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SWEETNESS and LIGHT

The Best Is Yet To Be

ONCE again our statisticians have been having a field day figuring out percentages, ratios, and comparisons in the increase of the profession's membership, and the C.A. body politic is surging with the invigorating flow of fresh blood. Newly admitted members will soon be making plans to start practices or form partnerships; members of longer standing will be looking for new students; and vocational guidance teachers will be stressing the rapid growth of the profession as a good omen for its future.

We often wonder why they will all forget to mention the correlative: not only is the rate of entry unusually high, but the rate of departure is extremely low. From May 1951 to May 1952, 478 new members were admitted into the profession, but just 28 out of a total of 4500 were called to make a permanent exodus. This means that the mortality rate is only six per 1000, which is two lower than the national average.

We had a teacher once who had come direct from the college of education to our school and had been teaching for seven years. Everyone referred to him as "Old Jonesy", although he was only 30, simply because all the others were middle-aged. When he was made head of department at another school, he was introduced to all and sundry as "Mr. Jones, our *new* teacher". He said that he felt twice as wealthy and ten years younger as a result of the move.

Sweetness and Light

We offer these thoughts as propaganda for the recruitment of accounting personnel and as balm for the wounds of those suffering under the slings and arrows of outrageous year-end closings.

Ain't It Romantic?

A READER on the West Coast writes:

Sir or Madam: I have read Mr. Glen E. Martin's article in the January issue of *The Canadian Chartered Accountant* and while approving of many of the principles enunciated, I thoroughly disapprove of one of his adjectives descriptive of an accountant's work. He states (p. 8):

> "Instead of thinking too much about the mechanical checking of figures, he [the auditor who adopts a business-survey approach] will be thinking more about what is behind the figures, and how they are related to the business operations. Thus, he tends to challenge and develop his imagination and to make his work more *romantic* and exciting." (Italics supplied)

Consultation with the Concise Oxford Dictionary reveals some of the following meanings which may be attached to *romantic*:

> "Characterized by or given to romance" (*romance*, according to C.O.D. is "picturesque falsehood exaggeration")
> "Remote from experience"
> "Fantastic, unpractical, quixotic, dreamy"

I rest my case.

COLONEL MOSSBACK

The counsel for the defence decided to fight fire with a bigger fire and so went scurrying to a Two-Volume Oxford to find, alas, that Col. Mossback was only too right. Those are the primary meanings of *romantic*. However, the word also has a secondary meaning—"marked by or invested with imaginative appeal". *Romantic*, says our Webster, is the op-

Sweetness and Light

posite of prosaic or commonplace, as well as the opposite of realistic. Well, accountants can't have their cake and eat it too. If they refuse to admit any connection with the romantic lest they fall into the habit of picturesque falsehoods, they must face an interminable succession of prosaic days in commonplace offices facing realistic facts.

We are glad that Col. Mossback did not pounce on the other adjective — "exciting". In trepidation we looked it up and found it to mean "arousing the passions"!

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COMMENT AND OPINION

Is Accounting Articulate?

TO BE articulate, we gather from our big Webster, means to be able to express oneself intelligibly. One of the chief objects of accounting is to explain the effect of financial transactions. All of which leads up to the query: is accounting articulate? Undoubtedly it is — to accountants. But what of those who are not accountants, in short, the general public? We believe that the latter look upon accounting in much the same way as our mediaeval ancestors looked upon alchemy in their day. It is an esoteric mystery to which they have not been admitted, and one, moreover, to which many of them have no desire to be admitted.

For this situation no one is really to blame. Accounting, whether it be a science or an art, has developed over the centuries to meet the requirements of an expanding industrial economy, and as the latter has increased in complexity so has the former. The absence of any ruling accounting authority combined with natural inertia no doubt explains the failure of accounting language to keep pace with the changes in accounting techniques. Then, at a relatively advanced stage of development, inject two new features: the demands of labour for an increased share of the national income and an income tax on business profits, with their concomitant demands for clarity and assurance. It is at that point of time that accounting's failure to be wholly articulate becomes a problem of far-reaching importance.

The accounting profession is by no means unconscious of the responsibility which rests on it to clarify the language of accounting so that he who runs may read. The British accounting societies played a vital role in the clarification of the accounting provisions in the British Companies Act when it was revised in 1948. Our own Institute has since the war set up two special committees to perform the same function in this country, and readers can read the result of the present committee's efforts in the April issue of *The Canadian Chartered Accountant,* which they will find an elaborate document. In this issue of the magazine will be found another instance of the profession's efforts in the same direction, namely the Research Committee's new bulletin on reserves, which is commented on elsewhere in this column. Still another indication of our growing concern for lucidity can be seen in the February issue of *The Tax Review,* which contains the joint submission of our Institute and the Canadian Bar Association to the Dominion government on the income tax. That document gives foremost place to a vigorous protest against the growing divergences between the accounting and tax concepts of business income, the chief cause of which,

it suggests, is a lack of understanding of accounting principles.

In this issue of the magazine readers will find two additional indications of the profession's interest and understanding of this problem. The first of a series of analyses of accounting usage in Canada, prepared by the C.I.C.A. Research Department, appears on page 129. On another page Miss Gertrude Mulcahy, of the C.I.C.A. Research Department, discusses at length the recent examination results, and it is apparent from her comments that one of the chief causes of failure in the examinations is a want of articulacy.

There is no doubt that the profession is fully conscious of the importance of this problem and, moreover, realizes that it is one of concern not to the profession alone but to the whole country.

Research Committee's Bulletin on Reserves

WE commend to the close attention of our readers Bulletin No. 9 of the Committee on Accounting and Auditing Research which appears on page 126 of this issue. In this bulletin, "The Use of the Term 'Reserve' and Accounting for Reserves", the committee unanimously recommends that accountants restrict their use of the term to describe amounts appropriated from net profits already determined and that it be not used to describe amounts which are required to be brought into account in the determination of net profit.

Fortunately, the committee placed this problem on its agenda almost two years ago. At that time its members believed that they should put their weight firmly behind attempts to reduce the unnecessary confusion resulting from the indiscriminate use of the term "reserve". Perhaps adherence to the recommendations in the bulletin will eliminate some of the confusion which has become so acutely apparent in the field of taxation.

As is pointed out in the bulletin, accounting thought has been advancing and new concepts have been developed to take care of changing business and economic conditions. Accounting practices which were regarded as adequate some years ago to cope with situations existing at that time are not necessarily applicable today and in some cases further consideration has resulted in improved procedures. In connection with inventory reserves the committee points out that since the war the necessity for a clearer delineation between amounts required for the proper determination of income and discretionary reserves has become more apparent. The committee recommends that reserves, properly so-called, should be created or increased only by appropriations of net profits or surplus and that all reductions in reserves should be returned to surplus. Charges should not be made against a reserve account which would otherwise fall against the profit and loss account and, conversely, credits that should fall to the profit and loss account should not be carried to a reserve account.

The committee thus points out clearly that reserves are in reality part of the shareholders' equity and it suggests that they be shown in financial statements as constituting part of that equity.

It is hoped that all our readers will find it possible to support the recommendations of the committee and do all in their power to put them into practice. In the use of the term "reserve", as in the wording of the auditor's report, indiscriminate variations in terminology serve no useful purpose and result only in needless confusion.

Analysis of Examination Results And Reasons for Candidates' Failures

By Gertrude Mulcahy, B.A., C.A.

Contrary to the opinion of many candidates the examinations are not designed as a trap for the unwary

AUTHORITY to use the appellation "Chartered Accountant" is granted only to those candidates who, having completed the required term of service, have presented concrete proof that they have qualified themselves by study and training to discharge their duties as members of that profession.

To use auditing terminology, the certificate of admission is issued only when the supporting evidence, that is, the examination papers submitted by the individual candidate, is found to be satisfactory. It has never been contended that an examination is a perfect means of determining a candidate's knowledge and ability, but to date it is the best that has been devised.

The Board of Examiners-in-Chief, made up of the representatives of the provincial Institutes, has been allotted the task each year of determining the supporting evidence which is to be deemed satisfactory. In order to guard professional efficiency, it is the duty of these examiners to see that the minimum qualifications have been met by each of the successful candidates. As it is impossible for every examination to cover all the topics included in the syllabus, the Board of Examiners-in-Chief endeavours to construct a set of examination papers, with a limited number of questions, which will bring forth from the candidates evidence of their knowledge of the subjects, of their ability, and of their initiative.

I. STATISTICAL ANALYSIS OF 1952 EXAMINATION RESULTS

Comparative Summary of Final Results

	No. of Candidates	Pass	Supp.	Fail	% Pass.	% Supp.	% Fail
Oct. 1949	661	214	169	278	32.4	25.5	42.1
May 1950	416	192	74	150	46.1	17.8	36.1
Oct. 1950	734	374	135	225	51	18.2	30.8
Oct. 1951	850	454	144	252	53.4	17.0	29.6
Oct. 1952	854	422	172	260	49.4	20.2	30.4

The above summary shows that the continuation of the upward trend in successes in the final uniform examination was not realized in the 1952 results. However, it is encouraging to note that the percentage of complete failures has declined materially over the last five examinations.

Upon analyzing the examination results, it was found that of those writing the full examinations (six papers), 48.2% obtained a clear pass in 1952, as opposed to 52.3% in 1951, and 50.3% in 1950. The percentage of failures in this category continued to decline — 25.9% in 1952, 26% in 1951, and 27.1% in 1950. Therefore, it can be concluded that although the percentage of clear passes has dropped, there has been a slight but steady increase in the ratio of success in either auditing and accounting (or both) when we consider those writing the full examination.

The results of the candidates writing supplementals are more discouraging. In this category, the students either pass or fail. The successes fell from 57.4% in 1951 to 53.7% in 1952.

In attempting to find the cause of the poor results in the 1952 examinations, it was found that of the ten provincial institutes, six showed an increase over 1951 in the percentage of clear passes, while three showed a substantial decrease and one a slight decrease.

In view of the few candidates from the Institutes of New Brunswick (12 in 1952; 12 in 1951) and Nova Scotia (20 in 1952; 21 in 1951), the decrease as shown above would have no effect on the overall picture. Similarly, the decrease of 4.5% for the Manitoba Institute resulted from three less passes with approximately the same number of candidates, since approximately 35% of the final candidates each year are Ontario students, any material change in the results of that Institute has a considerable impact on the overall results. Had Ontario maintained its 1951 percentage of clear passes, the overall percentage of passes would have been 54.4%, an increase of 1% over 1951.

Congratulations are in order to the Prince Edward Island and Saskatchewan Institutes for their evident improvement. The combined efforts of the Quebec Institute and McGill University in improving their course of instruction have certainly produced the desired results. Not only did McGill University capture the first prize for the whole Dominion, but it also showed an increase in passes over 1951 of 15.8%.

The British Columbia Institute, which combines a carefully planned series of lectures with the C.A. course of instruction, again brought forth the highest percentage of successful candidates, having

% Passes in 1952 and 1951

	1952	1951	Change
Alberta	46.	45.2	+ .8
British Columbia	70.	69.4	+ .6
Manitoba	49.1	53.6	— 4.5
New Brunswick	50.	77.	— 27.
Newfoundland	50.	40.	+ 10.
Nova Scotia	55.	66.7	— 11.7
Ontario	50.3	64.4	— 14.1
Prince Edward Island	33.3	—	+ 33.3
Quebec	45.3	40.9	+ 4.4
Saskatchewan	46.5	33.9	+ 12.6

a 15% margin over its closest contestant, the Nova Scotia Institute. In each of the past five uniform examinations, the British Columbia Institute has ranked either first or second in the percentage of successful candidates.

Analysis of October 1952 Final Examination Results

	No. of Candidates	Pass	Supp. Aud.	Supp. Accty.	Fail	% Pass	% Supp.	% Fail
Full exam.	664	320	106	66	172	48.2	25.9	25.9
Aud. supp.	86	51			35	59.3		40.7
Acctg. supp.	104	51			53	49		51
	854	422	106	66	260	49.4	20.2	30.4

Auditing Papers Only[1]

	No. of Candidates	Passed Auditing No.	Passed Auditing %
Full examinations	664	386	58.1
Auditing supplemental	86	51	59.3
Total	750	437	58.3

Accounting Papers Only[2]

	No. of Candidates	Passed Accounting No.	Passed Accounting %
Full examinations	664	426	64.1
Accounting supplemental	104	51	49
Total	768	477	62.1

Comparative Summary of Intermediate Results

	No. of Candidates	Pass	Fail	% Pass	% Fail
Oct. 1949	715	387	328	54.1	45.9
Oct. 1950	761	395	367	51.9	48.1
Oct. 1951	676	385	291	56.9	43.1
Oct. 1952	685	347	338	50.7	49.3

[1] The percentage of passes in auditing does not appear to vary depending on the number of papers the candidate writes.

[2] The percentage of passes in accounting is significantly higher for the full examination classification than for the accounting supplementals.

The percentage of passes on the 1952 intermediate examination was the lowest of the last four examinations.

In a comparison of the 1952 and 1951 intermediate results by Institutes, four Institutes showed an increase in the percentage of passes, while four Institutes showed a decrease, and two Institutes showed no change. If the Institutes of Alberta, Nova Scotia, and Prince Edward Island had maintained their 1951 percentage, the total number of passes would have been increased by only five.

However, if the Ontario Institute passes had not decreased by 14.3%, the overall percentage of passes would have been 56.7, which is approximately the same percentage as obtained in 1951.

The British Columbia Institute obtained the highest percentage of passes as well as producing five of the eight highest ranking students in the Dominion.

II. SOME OBSERVATIONS ON THE ACTUAL SOLUTIONS SUBMITTED

To assist future candidates in overcoming the faults apparent in recent candidates' answer papers, it was deemed advisable to bring before the members and students, by analysis of the 1952 uniform examinations, some of the general and specific reasons which appear to cause failures.

Examination questions are designed to bring to light not only the candidate's knowledge of specific theories and procedures but also to find out if the candidate is able to apply the knowledge which he has acquired to particular circumstances. The nature of the chartered accountancy profession, as well as the services rendered by it, make the latter objective the more important.

There are two types of examination questions:

Essay—requiring the discussion and/or the application of auditing and accounting theories;

Practical—requiring, in part, the preparation of statements, journal entries, calculation for and preparation of schedules, etc.

General Comments on Students' Answers

A review of the supervisors' and markers' comments prepared during the course of the actual marking of the examination papers brought to light the following:

(1) Students, as a whole, did well on the straightforward questions which asked for specific procedures or principles. This type of question required the student merely to reiterate the material set out in the text books and in the course of studies. However, many candidates failed to recognize these known principles and theories when presented in relation to a particular set of circumstances.

(2) In the essay type questions, the students were unable to present clearly and correctly the information required. Excessive verbosity, poor English, disregard for correct terminology, failure to present information in logical sequence, and illegible writing made it difficult for the markers to ascertain the substance in the students' answers, and in many instances completely obscured any apparent knowledge of the subject that the students might have had. Particular reference was made to those questions requiring answers in the form of letters or reports. The following comment was submitted by one of the supervisors:—

> The quality of letters or reports, from the point of view of presentation and content, was considerably below the level

which we feel is desirable. In order to improve this situation, we feel that more stress should be put on report writing in the correspondence courses and that course instructors should, perhaps, be requested to make more critical and detailed comments on form, grammatical construction etc.

(3) Statements and schedules required in many of the practical type of question were for the most part sloppy and slip-shod.

(4) In many questions certain groups of candidates seemed to do exceedingly well, whereas other groups produced rather poor results. One supervisor commented on this peculiarity as follows:

I am very much of the opinion that differences in marks obtained by candidates result either in the course of study that they take, or the type of office in which the candidates get their training.

Reasons for Failures, with Reference to Specific Questions on 1952 Uniform Examinations

A lack of knowledge of accepted fundamental principles has always been recognized as the prime cause of failure in an examination. However, a great many candidates who appear to know these basic theories fall down badly through a lack of knowledge of their application, an inability to interpret questions properly, and a failure to answer the requirements of the problem. The following comments, relating to specific questions in the 1952 uniform examinations, illustrate how these deficiencies contributed to the downfall of many of the candidates:

Lack of Knowledge

Question 1, Final Auditing 1 — Ethics and Professional Problems

In light of the accounting irregularities and tax fraud as set out in the body of the problem, the students were asked to state what a C.A. would do under two assumptions. This question was classified by the examiners and the markers as practical and relating to a situation of current importance. The markers classified the standard of the candidates' answers as poor and suggested a complete lack of knowledge as being the reason for the candidates' difficulties.

Questions 1 and 3 — Final Accounting 1 — Costs and Variances

The calculation and treatment of variances in various types of cost systems was the key to each of these problems. It was evident from the solutions submitted that not only did most of the candidates not appear to have mastered the principles involved in determining the causes of variances, but also a great many were completely ignorant of the fact that there were such analytical tools as price and efficiency variances.

In Question 1, a great many students wasted considerable time preparing full statements of budgeted and actual costs. It was the consensus of the markers that something is lacking in the area of cost accounting either in the course of studies or in the application of the students.

Misinterpretation of Requirements

Question 5, Final Auditing 1 — Non-Consolidated Subsidiary Companies

This question required a knowledge of the auditing principles relating to the receipt of dividends from a non-consolidated subsidiary company, of the legal requirements to be met in the financial statement of the parent company, and of the points to be considered in deciding whether to issue consolidated statements. A great many students misinterpreted the (b) part of this question, setting out the details of the profit and loss statements required by s. 113 of the Companies Act, 1934 (Canada) rather than the in-

formation relating to the non-consolidated company's profit or loss, as required by s. 114 of the Act.

Failure to Read Information Provided in Question — Padding

Question 2, Final Auditing II — Consolidated Subsidiary Company

The requirements of the question read as follows:

> In the course of the statutory audit of C Co. Ltd., and subsidiaries what information is needed by CA regarding the subsidiary D Co. Ltd. and how should this information be obtained?

It was set out in the body of the question that CA was not the auditor of the D Co. Ltd.

Through a lack of careful reading the students both misinterpreted this question and failed to answer its requirements. The mere mention of the company being incorporated under the Dominion Companies Act was taken as an indication that the requirements must be dealt with from the legal point of view. The D Co. Ltd. was considered to be a non-consolidated subsidiary company even though the question stated: "Only the consolidated accounts, in which all the subsidiaries are consolidated, are to be submitted to the shareholders". Consequently the solutions submitted by the candidates were made up almost entirely of detailed discussion of the requirements of s. 114 of the Companies Act. A key point of the question, namely, that CA was not the auditor of the D Co. Ltd., was missed by most candidates. To add to the confusion, those students who appeared to understand the question and its requirements introduced extraneous material such as goodwill.

Inability to Analyze Information

Question 6, Final Auditing II — Decrease in Net Profit, Causes and Possible Correction

This practical type question required the students to analyze, by departments, the statements of net profit, to bring to light the causes of a decrease in the net profit and the possible means of correcting such a decrease. This question was designed to present a situation which might easily arise in everyday practice, but unfortunately the urge to get something down on paper resulted in a complete lack of careful planning of answers and in a misunderstanding of the nature of the problem.

In the actual mechanics of the question, for the most part, the instructions relating to the allocation of expenses were not followed. The majority of the students either failed to produce comprehensive statements or, what is more serious, were unable to analyze and interpret the statements that they did draw up.

Failure to Carry Answer to a Logical Conclusion

Question 5, Final Auditing III — Arrangement with Creditors of Company in Financial Difficulties

A situation was presented in which the creditors of a company were pressing for payment of their accounts. The cash to be realized if the company went into bankruptcy, and the prospects for the following year if the company continued in operation, were both set out. The candidates were required to prepare the recommendations and supporting statements that the auditor would present to the creditors to influence their course of action.

Unfortunately, most of the candidates missed the point altogether. The majority based their conclusions on a budgeted manufacturing and profit and loss statement without attempting to fore-

cast the current position of the company by means of a cash budget. This misinterpretation was ridiculous since the whole problem evolved around the necessity to pay off the creditors in cash.

Inability to Visualize a Practical Situation

Question 4, Final Accounting III — Evaluation of Refinancing Proposals

The candidates, confronted with three alternative proposals of refinancing were asked to prepare a letter and supporting schedules, setting out the course of action which they would consider to be in the best interests of the shareholders.

The majority had no idea of what was required in order to be of assistance to the shareholders and made no effort to prepare analyses of the various proposals. The candidates seemed just to put down all the figures that they recognized with no idea as to how they were going to use them. The content and form of the letter required was very poor.

General Comment on Above Questions

In practically all the above questions, the examiners had introduced various situations with which the chartered accountant of today may find himself confronted. If the examinations are going to test the candidate's ability to meet diverse situations, then of necessity they must reflect the increasing complexities of the modern accounting world. Failure of a candidate to cope with situations which will face him in actual practice indicates a deficiency in the approach of the candidate to the whole training program.

Intermediate Examinations

While the purpose of this article is to bring before the membership the main causes of the failure of the final candidates to give proper evidence of their ability, some comments on the overall deficiencies of the intermediate students will show that the causes are apparent at the intermediate level as well.

Intermediate Auditing

The intermediate students apparently felt obligated to set out audit procedures as the answer to all questions on the auditing papers regardless of the stated requirements. The markers' comments on the question calling for the audit procedures re verification of the raw material inventory of a manufacturer of children's clothing were particularly interesting — "Candidates merely parroted lectures and text books without considering whether the information so parroted applied to this situation". A tendency to wander off the subject, to enter into an extensive discussion of procedures and give material not called for, and to fill up answers with repetition of points, made it rather difficult for the markers to determine the actual knowledge of the candidates.

Intermediate Accounting

The general deficiencies as set out above, particularly the lack of independent thought, were also mentioned by the markers of the intermediate accounting papers.

The inability of the students to think for themselves was definitely shown in the answers to the question calling for the calculation and significance of the ratios to be used in comparing two companies in the same line of business. Candidates were able to calculate ratios — in fact the markers were amazed at the ability of the students to invent ratios — but when it came to interpreting the story that these ratios told, their ability disappeared.

The quality of the work sheets submitted for the manufacturing statement

and for the profit and loss statement on a departmental basis was a distinct surprise. This was considered to be a very practical type of question and one with which the candidates should not experience too much trouble. A similar type in the 1951 examination papers produced very good results. Most candidates failed to realize that the stating of a mere arithmetical proportion for the distribution of expenses to departments is not complying with the requirement to indicate the basis used for such distribution of expense items.

The question asking for an explanation of terms and principles relating to the capital stock was one that required a depth of thought which the intermediate student apparently does not have. This problem was actually based on questions asked by a stenographer in an accounting office. It does seem rather peculiar that students who have been studying accounting have been perfectly content to accept such terms and principles without ever considering their import.

Conclusion

Many of the candidates appear to contribute to their own downfall by failing to give themselves a fair chance. If they would take those few seconds to make sure they have read the question fully and accurately and have determined exactly the answer asked for, they would avoid wasting time in non-productive thinking and writing. Many candidates appear to waste at least a quarter of their time in this fashion.

The poor quality of expression of many candidates may be due to a deficient knowledge of the language as a means of communication or may be evidence of the inability of the candidates to organize their thoughts. Either deficiency could be at least partially overcome by practice. Illegible handwriting and sheer carelessness in expression and in statement preparation also contribute to student failures.

While many of the candidates who fail obviously have only a sketchy grasp of the subject involved, others appear to have a fair knowledge of accounting and auditing theory but fail to recognize its application in a given case. Here again, practice in organizing his thoughts may assist the candidate to be fairer to himself in the examinations.

In some cases it is obvious that candidates approach the examinations as though they were designed as traps to catch the unwary and that it will only be by luck that they will succeed. As stated at the outset, for all practical reasons the examinations are designed to sample the candidates' knowledge in certain areas. The results of this sampling are assumed to indicate the candidates' grasp of the whole field. Candidates need only to have a sound knowledge of the subject and be fair to themselves to secure a pass.

Ramifications of Marginal Costing

By George Moller, D.Jur., C.A., R.I.A.

A study in management accounting

Setting the Stage

The need for up-to-date information on costing techniques becomes more emphasized in a market situation where supply and demand are closer to a balance point and where in fact supply in an increasing number of cases is starting to exceed demand.

The accountant will be more frequently called upon to render assistance to the manager who has the responsibility and, therefore, the authority for price determination. It is the contention of this study that the accountant can only discharge his duty of supplying impartial and reliable information on costs for price determination if he is familiar with the technique and problems of marginal costing as contrasted with conventional total costing.

In striving to discern the philosophy of life on this continent, the economist might come to the conclusion that a steady increase in the standard of living of the widest number of people is the goal the free enterprise system is striving for. This becomes clear when one gropes into trends like the anti-combines legislation which is directed against restraint of trade practices for the benefit of the few, or considers the developments in collective bargaining, e.g. wage rate increases based on the productivity increase factor.

This excursion into political economy is connected with our theme of marginal costing to the extent that the marginal cost approach will very often lead to the reduction of prices accompanied by increases in volume with equal or even improved profit results for the *entrepreneur* and thereby in effect contribute to an improvement in the standard of living.

Pricing and Costing

How can a costing approach lead to such far-reaching consequences? There may be people who claim that pricing comes first and costing afterwards, but we would prefer to start with the permissible assumption that price determination usually follows cost estimating. Unless the manager determines prices by blindly following the price list of his competitor or competitors or simply using the rule of thumb, he is bound to call

An address to the Niagara Chapter of the Society of Industrial and Cost Accountants, Niagara Falls, October 22, 1952

his estimator in and present him with the problem of forseeable costs for the product under consideration. Depending on the cost finding method in the industrial enterprise involved, the estimate of the basic costs, i.e. direct material and direct labour, will be relatively accurate and reliable.

Calculation of Overhead

The next step, i.e. the calculation of manufacturing overhead, adds to the estimate the confusing assumption of normal capacity or normal volume. How often is the industrial accountant confronted by management with the question, "How much is the overhead on this product?" If the accountant is true to his professional standing, he should answer this question always with a rather involved qualification as to the assumptions which he has made in determining the overhead rate for the manufacture involved. These qualifications, even if expressed adequately, are not always understood by the engineer, salesman, lawyer, or self-made man who may be the manager.

The more diversified the production of the plant, the more difficult it is to determine or predict normal capacity and encompass all the possible alternatives into the qualifications preceding the establishment of a manufacturing overhead rate in our assumed situation. This becomes clear if one realizes that the overhead rate is usually expressed in percent of prime costs, either material or labour or a mixture of both, and covers fixed, semi-variable, and variable elements. If the direct elements vary substantially for the different products of the plant, the increase in the production of one product with, for instance, a large labour content, replacing the production of another product with, let us say, a larger material content, changes the assumptions which have led to the calculation of overhead rates based on the normal or expected volume.[1]

Although the flexible budget replaces the fixed budget in a growing number of enterprises, the use of marginal costing has not yet found the general appreciation in industry which it seems to deserve.

Term "Marginal Costs"

In order to avoid confusion, we should first recall that marginal costing is not the only name under which this approach to costing is known. In fact, the expressions "marginal costs" and "differential costs" do not appear in the index of Lang's *Cost Accountant's Handbook* nor can they be found in the recent text book "Cost Accounting", by Professor James B. March. With the deplorable lack of uniformity in the cost accountants' terminology, not less than three expressions appear in literature for practically the same concept. Marginal costing derives its meaning from the margin, i.e. the difference between the costs of certain number of units (n) against the cost of a number of units increased by one (n + 1). If the certain number of units (n) has absorbed the overhead charges of a fixed or periodic nature, the cost of the one (1) additional unit will equal exactly the amount of direct labour, material, and variable overhead expense caused *directly* by its production. From this relationship to direct costs, the technique has derived its other name, "direct costing". The third name preferred by the engineering-minded is "increment costs", i.e. directing one's attention exclusively to the one additional unit, the

[1] Overhead rate:
(Total overhead considered apportionable to labour, divided by total direct labour costs) plus (total overhead considered caused by material handling or depending on physical volume divided by total direct material cost).

increment in production, i.e. costs brought about by this one unit and the proceeds therefrom.

Sometimes one also sees the expression "alternative costs" used in this connection which seems less meaningful as it only stresses the fact that costs are not one exclusive concept but permit alternative determinations.

It is not the aim of this study to advocate marginal costing for general use in preference to the usual form of total costing but rather to show that a cost system should be developed in such a manner that it allow marginal costing calculations, using the accumulated cost information without cumbersome redistribution or analysis.

Although differential costs have first been defined in 1923[2] they have until recently not been too frequently discussed in literature. The increasing attention which is given to marginal costs is indicated by the numerous articles which have appeared since the end of the Second World War. One whole book by F. C. Lawrence, M.C. and E. M. Humphreys has been devoted to marginal costing. This book is a contribution from England which to the writer's knowledge has not been quoted on this continent so far.[3] The most recent text, "Cost Accounting" by Matz, Curry, and Frank, devotes a full chapter to differential cost analysis which contains a very concise but lucid presentation of the matter. With all this literature on the subject existent, this study could seem superfluous. We hope that the reader will find it justified as a signpost directing him to this technique, sources of information thereon, and the following practical considerations encountered in its attempted application.

Dr. George Moller, D.Jur., C.A., R.I.A., practised law in Czechoslovakia for a short time and was secretary to the Bohemian Union Bank before coming to Canada in 1940. Entering the accounting profession, he joined Geo. A. Touche & Co. in Toronto and in 1946 was admitted to the Ontario Institute. He is presently treasurer of Robertson-Irwin Ltd. in Hamilton and a director of the Hamilton Chapter of the Society of Industrial and Cost Accountants.

Different Approach

The customary cost accounting system allocates and distributes costs without distinguishing between *fixed costs* which I would call for our purposes "temporarily unavoidable costs" and *variable costs*, which perhaps could be described as "immediately avoidable costs". Most enterprises which use cost analysis make this distinction but very few arrange their cost recording and cost data accumulation on the basis of this distinction. If a cost analysis of marginal cost nature is then required, the cost accountant has to go back and disentangle his figures, trying to eliminate the fixed or temporary unavoidable elements. To avoid this necessity, the split into periodic and variable costs has to be made at the source, i.e. when costs are accumulated and before they are distributed.

The technique which permits this procedure requires merely a split of all expense accounts which contain fixed expenses into two sub-accounts, one for the fixed and one for the variable part of the expense. In the

[2] J. M. Clark — "The Economics of Overhead Costs" (Chicago; University of Chicago Press, 1923)

[3] "Marginal Costing", by F. C. Lawrence, M.C. and E. M. Humphreys

monthly accumulation of the expenses, the fixed component is deducted from the total monthly expense and entered on the "F" sub-account for the particular expense category. The remaining balance then represents the variable element and is entered on the "V" sub-account. It is, of course, necessary to watch the fixed element of the costs for increases or decreases which have nothing to do with the fixed character of the expense. If, for instance, the plant manager's salary is considered a fixed expense, an increase in his salary must lead to an increase in the fixed portion of the total expense in which his salary is included. The working papers which have lead to the initial determination of the fixed expenses are therefore an integral part of the system and should be reviewed regularly in order to keep the figures up to date. In enterprises which use cost analysis regularly, this review of fixed costs is necessary in any case and therefore would not represent an additional effort in accounting.

The following definition is taken from a special bulletin issued by the Society of Industrial and Cost Accountants of Canada, "The Breakeven Point of Operations and Profit — Volume Relationship", by Charles H. Gleason:

> *Marginal Balance* — Marginal balance is the dollars of remainder or difference between sales and all variable operating costs. It is the dollars of sales available for payment of fixed operating costs and profits.
>
> At the breakeven point of operations the marginal balance is just equal to fixed operating costs. When operations are above the breakeven point, the excess of marginal balance over fixed costs is the dollars of profit from operations. When operating below the breakeven point, the amount by which marginal balance fails to equal fixed costs is the loss from operations.

Ivan M. Farmer has emphasized[4] that the usefulness of differential costs depends upon their reliability and the degree of accuracy used in segmenting the component parts into fixed, semi-fixed and variable costs.

Marginal Cost Approach

The marginal cost approach requires a change in the set-up of the profit and loss account. The variable costs only are deducted from the sales proceeds; from the remaining gross profit margin the period costs are deducted, and the remainder, if any, represents the net profit. In the valuation of the inventory, fixed costs are completely disregarded. Over- or under-absorbed overhead, therefore, does not enter the picture.

The conventional cost concept assumes the existence of a total unit cost which is only correct if the volume is fixed, whereas the marginal concept works with the actual variable unit cost plus actual fixed costs. The marginal costing approach does not disregard fixed costs eventually but treats them as temporarily unavoidable. This is often overlooked by the critics of this method. There can be no doubt that in the long run the fixed costs of an enterprise must be recovered from sales proceeds if losses and final bankruptcy are to be avoided and that a profit can only be made if an excess over variable and fixed costs can be achieved in sales proceeds. The question is only what sales should recover the fixed overhead and to what extent it is reasonable to accept business which only contributes to overhead without returning its full share on a total costing basis.

Case History

It is always difficult to follow an entirely abstract presentation of a highly technical problem. The following adapted case history will therefore be used to show the practical application of marginal cost thinking to managerial decisions, based on information provided and interpreted by the cost accountant:

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[4] In *Cost and Management*, October 1949

Enterprise

Our case took place in a sheet metal plant with twenty different product groups, using the job order system and prime cost accumulation by work orders. Overhead is not allocated in the books of account, but statistically accumulated for each product group and used periodically for determination of overhead rates. These overhead rates comprise fixed and variable expense with the fixed cost distributed on the basis of the expected production and sales for the year. Administration and sales costs are distributed on the net sales dollar basis, i.e. after eliminating all directly applicable sales expense, e.g. commissions, freight-out, discounts.

The volume of production during the first part of the year is habitually considerably smaller than in the second half year. The sales forecast calls for sales of $10 million worth of products based on the prices determined at the beginning of the year. The production and resulting billings occur usually distributed over the year: 15% first, 20% second, 25% third, 40% fourth quarter. This required in the fourth quarter, a volume of production which brings certain work centres, through which the bulk of all production has to pass, close to full production in three shifts. In view of the connection of the plant with the construction industry, the difficulty of storing large quantities of the bulky finished products, and the dependence of delivery dates on the progress of the projects for which the products are on order, long-term production scheduling is often beyond the control of the plant management.

Problem

The sales manager saw a chance of selling two thousand pressure vessels to one big customer, delivery to start three weeks after receipt of order. This sale had been counted on for the spring when the sales budget was prepared at the end of the preceding year. It was now September, and the sales manager had reconciled himself in spring to the loss of this sale because of sharply reduced prices then quoted by the competition. He is still eager, though, to book the sale and thus live up to his original sales forecast, although at a substantially reduced price.

A conference was called, bringing together the general manager, sales manager, works manager, and comptroller to discuss the problem.

The first question posed by the general manager was:

At what price can we book the order? The list price for the pressure vessel, f.o.b. plant, was $50.00. This price had been arrived at in the following way:

Material		$ 15.00
Labour		10.00
Total prime cost		25.00
Manufacturing overhead based on material 33-1/3%	5.00	
Less fixed overhead	3.00	2.00
Less fixed overhead based on labour 100%	10.00	
Less fixed overhead	3.00	7.00
Variable cost		34.00
Add:		
Fixed Manufacturing overhead	6.00	
Fixed Administration cost—5%	2.50	
Fixed sales cost—5%	2.50	11.00
Profit at the rate of 10% of sales		5.00
		$50.00

(Not providing for commission, discount, freight allowance, if any.)

The sales manager assumed that in view of his knowledge of prices quoted by the competition, we would have to:

(a) Quote our price on a "delivered

to the customer's premises" basis, i.e. we will have to absorb $1.50 delivery expense.

(b) Lower the delivered price to $43.00.

We will, therefore, receive a net of $41.50 against a list price of $50.00.

The comptroller stated that the marginal cost of this pressure vessel amounts to $34.00 per unit..[5] We recover, therefore, all direct costs and have $7.50 per unit left to cover the total of $16.00 fixed overhead in manufacturing, sales and administration.[6] Thus the margin of $7.50 is not sufficient to cover the full overhead quota on a complete absorption basis.

The discussion highlights the following two points:

(1) Will the sale of two thousand units to this big customer in no way affect our regular sales in this product, by making the competition on the regular market keener and induce them to reduce their prices in this market after our capturing this one big order?

If this question can be answered negatively, it would make sense *pricewise* to accept the order.

(2) Will our production facilities, in the limited time available for the production of this additional business, be overtaxed?

The works manager states that, in his opinion, it will be possible, by introducing a third shift in the departments through which the pressure vessels have to pass, to produce the 2,000 units within the period from the receipt of the order to the delivery date stated by the customer. The addition of the third shift poses certain problems which the comptroller summarizes by stating that the third shift increases the direct costs through the night shift differential of 7c per hour and the loss of one half-hour for lunch in accordance with the union contract. In addition thereto, there are intangible factors which, by experience, reduce efficiency in the night shift (inferior quality by lack of skilled supervision, tiredness factor, unavailability of maintenance crews or executives for decision, etc.)

The prime labour costs will, therefore, go up by $1.28 per unit.[7] This increase should, though, be considered an additional reduction of proceeds and not an increase in prime labour cost because it does not cause any direct manufacturing overhead with the exception of unemployment insurance, workmen's compensation, premium paid for holidays and premium paid for public liability insurance, which factors are a direct function of the direct wages. These factors are equal to roughly 7% of the wages.

It would, therefore, be feasible to deduct the aforementioned amount from the proceeds of the units instead of changing the calculation of the list price.

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[5]

Prime cost		$ 25.00
Manufacturing overhead total	$15.00	
Fixed therein	6.00	
Variable manufacturing overhead		9.00
		$34.00

[6]

Manufacturing overhead fixed	$ 6.00
Sales and administration	5.00
	$11.00

[7] Labour $10,000

Average $1.50 per hour = 7.3 hours per unit at 7c per hour	$ .51
½ hour per 8 hours 73/16 = .46 x $1.50	.69
	1.20
Add social security charge 7%	.08
	$1.28

The comptroller made the remark that the actual labour cost on the pressure vessel, recently, was in excess of the amount of $10.00 shown in the calculation. This experienced labour cost was not caused by shift work and the question was brought up by the comptroller whether there is any reasonable expectation of reducing the labour costs by increased productivity. The works manager assured the meeting that we all have reason to believe that we will be able to reduce the recently experienced labour cost in the production of the unit from $11.00 to $10.00, which latter figure, originally used for the calculation of the sales price, has since risen because of the recent wage increase granted to our union without corresponding improvement in the productivity; we are now trying to offset this cost increase with the help of additional equipment. The depreciation of this additional equipment, of course, has not been taken into account when calculating the overhead rate for this product group. The comptroller remarked that the depreciation of the new equipment could be disregarded for our purposes because it is definitely of the sunk cost kind and, whether we accept the order or not, will have no influence on our past decision of acquiring this additional equipment with which we are definitely settled; in short, the depreciation provision for the new equipment increases the fixed cost which we disregarded for our purpose.

The works manager reminded the meeting that we can hope for the reduction of labour costs only if we use this equipment which allows us to produce two thousand units in two shifts in a period of eight weeks. This would not be possible in addition to our normal production covering our normal sales in small lots scheduled for this period.

The general manager drew the conclusion that the acceptance of the order in question would then, at least partly, be at the expense of current orders at the regular list price. He further questioned the possibility of obtaining sufficiently trained personnel for the third shift. The works manager admitted that the prospects to hire additional skilled labour would not be too bright, taking into account that the third shift would be only required for a limited period of time.

The comptroller also mentioned the fact that in the fourth quarter the administrative staff of the company would be working close to capacity in order to cope with the increased work volume in this period of the year. This might lead to an increase in the office staff by temporary workers which would cause an increase in the administrative overhead. Such an increase would, again, decrease the proceeds from this specific order, as it would be directly caused by this order and the hiring of additional work forces to cope with it.

The question of material procurement also enters the picture as the short delivery term for the additional units will make it impossible to allocate material from the normal raw material supply source to this order, and require borrowing material, already on order, from orders scheduled for a later period, and replacing this borrowed material later by material to be ordered now for later delivery. The possibility cannot be completely excluded that this solution may lead to difficulties in the prompt delivery of the orders from which the material will have to be borrowed.

The general manager sums up the discussion by the statement that under the circumstances, it seems not desirable to accept the order in question for an additional 2,000 units at a reduced price. The contribution of this sale to the overhead recovery (gross profit margin) does not seem sufficient in view of the numerous difficulties caused by the order

under discussion, which could endanger the production and delivery on time of regular orders already booked or expected to be booked.

Conclusion

The review of the considerations entering into this discussion cannot claim complete coverage. Questions like the credit risk of the specific business or the effect the peak load would have on future demands in labour negotiations have not been touched upon. The complex discussion of the possible results of the additional order on the sales incentive bonus plan existing in the company would present a study of its own and we must forego, therefore, the temptation of presenting this argument.

The reproduced discussion should not only show the practical application of marginal costing, but also emphasize that any decision concerning the acceptance or refusal of an order not resulting in a direct contribution to the net profit of the enterprise will depend on several considerations which are not all in the realm of costing. It would, therefore, be bordering on conceit to claim that the accountant could or should provide all the material required for making managerial decisions, although he should be able to help solve a good many of them. One of his tools is the marginal cost approach. This approach, again, is not a panacea, but has to take its place in a row of several other approaches which may, under different circumstances, direct the management's thinking. We may just mention some of them: imputed costs; replacement costs; sunk and out-of-pocket costs; opportunity costs.

All these approaches have their specific applications and the accountant who wishes to serve management well should beware of becoming one-sided and prejudiced in favour of one particular approach like marginal costing.

It may, perhaps, be appropriate to close this study with a quotation from the critical review of the marginal costing approach to cost problems in an article "Overhead in Perspective" by H. Kirkham, F.C.W.A., in the May, 1952, issue of *The Cost Accountant,* the official journal of the Institute of Cost and Works Accountants in England:

> My criticism is levelled at the unimaginative and partisan controversy which has gone on for some considerable time and which may serve to underline the need for common sense in addition to technical knowledge in our approach to such matters (i.e. Marginal Costing). The advocates of this technique (Marginal Costing) recommend the separation of fixed from variable overheads and would have us believe that to attempt to identify the so-called fixed overheads with products is unnecessary. The extremist opponent of this doctrine denies the very existence of fixed overhead, and has been known to go to great lengths to prove his case by drawing a series of impressive curves which prove without doubt (to himself at any rate) that all cost is variable in the long run.
>
> Let us be realistic and accept the fact that in the short term, an intelligent assessment of fixed overheads can be made, and, by deduction, the variables can also be assessed.
>
> All this does not imply that one ought to adopt a marginal cost technique to the exclusion of all others, but is merely in support of the belief that the acceptance of certain features "may" be advantageous "in certain circumstances". Denial of its usefulness constitutes evidence either of reaction or egotism, or both.

Costing in the Shoe Industry

By C. R. Kidner, C.A.

In this industry, incorrect costing may result in disaster at short notice

THE shoe manufacturing industry is one of the most competitive of all industries. Why? Perhaps age has something to do with it. The census of 1871 reported in excess of 4,000 shoe manufacturing establishments. These were not factories in the modern sense, as the number of employees averaged only four per establishment. Nevertheless, at that time it was Canada's third largest industry. In those days the handicraft system was general and little machinery was used. The period of 1870—1880 was marked by the introduction of shoe making machinery. The development was rapid and by 1880 most of the larger operators were equipped with machinery. In 1900 the census changed its method of enumeration, recording only those establishments employing five persons or more. In 1900 there were reported 179 plants. Today there are some 270 manufacturing concerns producing 33,000,000 pairs annually for a value of about $120,000,000 at manufacturing level.

Another factor contributing to the competitive angle is the ease with which one can go into the business. Capital requirements are not too heavy. Much of the expensive equipment is leased and materials can be purchased on a reasonably short schedule, and in numerous cases on favorable terms. Most of the companies are family-owned. Many of the plants produce only one type or style of shoes and production ranges from 200 to 1,000 pairs daily. The largest company in Canada produces about 9,000 pairs daily.

As a result of this competitive condition, average profits on sales have been unusually low. In spite of the expression "what a price for a pair of shoes", shoes are sold at the manufactured level at a price closer to actual cost than most items of apparel. It should be remembered too that there are two items with each purchase or sale. The consumer should appreciate the fact that in many types of shoes, there are over 150 operations for each shoe. It is therefore obvious that costing to the manufacturer becomes a serious problem and in view of the narrow margin of profit dictated by competition the incorrect solution of this problem may result in disaster at short notice.

Many shoes of different styles are sold across the board at one price al-

though the cost of the various styles included in the group may differ considerably. Definite cost of each style should be determined. A recent survey of shoes sold across the board by a leading producer showed the cost of various styles included at one price to be as follows. Using 100% as the lowest, upper materials varied from 100% to 200%, total material from 100% to 121%, labour from 100% to 117%.

Costing

Particular costing practices used depend upon the needs and preferences of the individual manufacturer. The aim in every case must be, however, to reflect with sufficient accuracy the cost of each shoe made. A factory producing only one style or type of shoe has a comparatively easy job of costing and is able to cost very closely. When two or more styles are manufactured in the same plant, many difficulties arise in the attempt to allocate costs to each style.

Different types of costing systems are found in the industry but the most common method is spoken of as "Current Estimated Costing".

Departments

The usual operating departments of a shoe factory are:

1. Cutting Room — Upper materials
2. Fitting Room — Upper fitting
3. Stock Fitting Room — Bottom materials
4. Lasting Room
5. Bottoming Room
6. Making Room
7. Finishing Room
8. Treeing and Packing Room

Departments 4, 5 and 6 are often combined, as also 7 and 8.

Cost Elements

Breakdown of costs on the average are:—

Materials	55%
Factory or direct wages	25%
Manufacturing expense	10%
Administration and selling	10%
	100%

Of the materials, 50% is upper materials and 25% bottom materials. The balance is mostly made up of small items, such as counters, box toes, shanks, eyelets, laces, tacks, wire, thread, and many more.

It is often said that it is the small holes that sink a ship. This is sometimes true in the shoe industry but it is not the small holes in the shoe that cause the trouble but rather the small holes in the two major items of material, namely, upper materials and bottom materials.

Costs are usually prepared on a basis of 100 pairs.

Detail of Estimates

Materials

Any item of cost than can be broken down in detail should show separately on the cost estimate sheet. This will cover the greater cost of materials of any shoe and only such items as thread, cement, tacks, inks, etc. need to be grouped and applied on an average. For many of the small items actual costs are known. For materials that are cut up in the factory, such as upper leather and linings, the cost per foot or yard is known and the important part is to estimate as accurately as possible the quantity needed for any particular pattern. A visual estimate of requirement is not sufficiently accurate for such important items of cost. One of the scientific systems in common use should be employed. This is not as necessary in a factory making only one type of shoe with few style changes as actual results on cutting can readily be

attained if proper cutting records are kept.

Labour

Direct labour is paid mostly on a piece-work basis. Details of each operation and price per 100 pairs are maintained for each type of shoe and are applied on the cost estimate sheet by departments. Time work can be applied in total or by departments and is calculated on a unit or percentage basis depending on a study made in any one factory.

Overhead

Manufacturing and administrative expenses are shown separately on the cost estimate sheet. The basis of calculation is discussed later.

Selling Prices

Selling prices are based, in the main, on the cost estimates because, outside of shoes made for stock, the work of producing the goods does not commence until after an order has been booked. True, samples are made of the shoes which have been costed but actual costs cannot be known until orders have been processed. Therefore on these cost estimates current and realistic figures should be used to the fullest extent possible.

Sundry

After the first estimate has been determined, the cost sheet must be kept constantly up-to-date on matters of important change. For example, if the price of laces went up 3%, this would not in itself be of sufficient cause to revise the estimate sheet. If, however, the price of leather took a sudden change, it would be mandatory to revise the cost estimate.

The original cost sheet should contain several similar columns providing for current change revisions.

In estimating leather requirements the average size of any range is used. For example, a women's shoe, sizes 3 to 10, widths A to EE might be costed on a size 6 C. The centre size is not necessarily the average size. Sales orders should be analyzed periodically in order to establish the best size for cost estimating. Some manufacturers neglect this check and use the same size season after season. A case in fact showed a manufacturer using a size 6 C for costing and some years later a check up revealed that 80% of this type sold by him were over 7½ D.

Mr. C. R. Kidner, C.A., R.I.A., was admitted to the Ontario Institute in 1935 and in 1936 he became associated with the Savage Shoe Company in Preston, Ont. as office manager. Today he is vice-president of that company which is the largest manufacturer of its kind in Canada.

Cost Proving

Accountants' "ideal cost systems" are those that "tie-in" with the accounting records. This is seldom found in the shoe industry as the results obtained do not justify the expense of the voluminous work entailed in compiling information and making the necessary monthly entries in the inventory, work in process, and other accounts. Such information, therefore, is kept in memorandum form.

Actual cost of shoes produced is easily obtained if proper records are kept. However, it is impractical except in special cases to trace the cost of one pair or one lot of shoes through its production and the usual procedure is to obtain bulk costs.

Raw materials are bulked as follows: outside material, lining material, bottom material, insole material, other material (sometimes called direct findings and composed of all items other than those mentioned and which are shown in de-

tail on the cost estimate sheet) sundry materials (called indirect findings and composed of those materials which are grouped and costed on an average).

Labour costs are obtained by departments from payroll records.

Overhead costs are procured from the accounting records.

Therefore, subject to any inventory of work-in-process or unused materials which had been requisitioned for, overall costs can be secured for any desired period.

A daily production sheet should be made which lists the sample or pattern number and number of pairs of each case lot of shoes put into production. The estimated cost of each production sheet can be obtained, using the same breakdown as for actual costs by taking the original cost estimate sheet for each sample and multiplying by the number of pairs of each pattern on the production sheet. This information and that from the actual cost memoranda provides the basis for comparison between estimated and actual costs. The degree of variation will decide what further investigation is necessary.

Various types of forms can be used for the above procedures but in the cutting-room and stock-fitting room each cutter should have a sheet which shows each case lot of shoes which he is to cut and the allowance for material for each lot. This allowance is to be on the same basis as that used on the cost estimate for each pattern, the amount of material given out to the cutter and the amount returned after he has finished the job. From this the actual gain or loss can be calculated, usually in feet. As leather is purchased in lots and each lot is priced, the dollar cost of leather used and gained or lost by each cutter is obtained. The number of sheets which a cutter might need in a day is dependent on the variety of leather and styles which he is to cut. At the end of any given period (usually a month) these sheets are totalled and the final summary should show:—

1. The name of the cutter.
2. The quantity of each type of leather or other material used.
3. The gain or loss for each type by footage and dollar value.

Wastage of leather is an important item in shoe costs, and cutting results should not be confined to an overall by department but should show the above information by each individual cutting operator. As mentioned previously, on the average 50% of material cost or 27% of total cost is upper materials whereas cutting-room labour costs would not on the average exceed 10% of total labour or 2½% of total cost. It is obvious that any percentage of leather waste is an important factor. There are often found in any factory outstanding cutting-room operators from a piece-work earning angle but more often than not, such operators show the poorest results on materials savings and too often are wasting good materials in order to achieve higher earnings. A bonus system on material savings is a good factor to consider.

As further evidence of the difficulty in tracing the actual cost of one shoe or case of shoes, let us consider leather used in the cutting-room.

Leather purchased for any one type or price line of shoes is received in grades, sometimes as many as four, and the price for each grade varies; also the quantities vary with each shipment. The cutter who has received several case lots to be cut, which are listed on his cutter's sheet previously referred to, also receives quantities of leather of more than one grade. He may cut different parts of different patterns from one skin or different parts from skins of different grades which have different prices. He

may be able to secure a part such as a tongue from sections of the skin which would otherwise be considered waste and which has actually been allowed for as waste in the original estimate. Cutting rooms must use every possible piece of material. These factories making different grades of shoes can take advantage of the waste or of poor skins not suitable for top grade but usable for lower grades. Leather used in a cutting-room for shoes might be likened to the eggs going into an omelette. You can't separate the leather going into the individual shoes any more than you can separate the eggs after the omelette is made.

Budgets and Overhead

Production and expense budgets are a must. Expenses can be applied to the production budget in various ways familiar to the accountant, such as unit basis, direct labour cost, direct labour hour, direct material, and others. Without discussing the merits of one as against the other, the most common methods in use in the shoe industry are the unit and direct labour cost basis. A factory making one type and size range of shoes will find the unit method the simplest and most practical. Factories making different processes find the direct labour basis more satisfactory as it more closely reflects the time element in the production cycle and most cost accountants believe in the theory that expense and particularly manufacturing expense is incurred in proportion to the passing of time.

Comparisons of overhead, estimated and actual, will be made for the same period as for other cost elements; however, certain types of factories have peaks and valleys in production and overhead will show over or under absorption during these periods. This should be considered before adjusting the figure for use on the cost estimate sheet. In any event, it is recommended that a tie-up be made at least every three months and adjustments made in the cost estimate sheets.

This paper sketches only a few of the problems in shoe costing, but perhaps the readers may feel that shoes have, after all, some real value.

(See p. 120 for sample estimate sheet)

1952-53 LIST OF OFFICERS, COUNCIL AND MEMBERS

Members of the C.I.C.A. are advised that copies of the 1952-53 Blue Book (List of Officers, Councils and Members), compiled as of May 31, 1952, are available from The Canadian Institute of Chartered Accountants, 10 Adelaide Street East, Toronto, Ontario. In order to offset to some degree the cost of publishing and to make the best possible use of revenues, it has been decided to charge $1.00 a copy for the Blue Book.

Sample Estimate Sheet

SAMPLE **STYLE** **LAST** **PROCESS**

BASE SIZE **CUTTING BASE**

DESCRIPTION

		DATE		DATE		DATE		DATE	
	Quantity	Unit Price	Cost	Unit Price	Cost	Unit Price	Cost	Unit Price	Cost
UPPER MATERIAL									
Outsides									
Quarter Lining									
Vamp Lining									
Backers - Doublers									
TOTAL — UPPERS									
BOTTOM STOCKS									
Outsole									
Insole									
Heel Base									
Heel									
Midsole									
TOTAL — BOTTOMS									
DIRECT FINDINGS									
Eyelets									
Buckles									
Box Toes									
Counters									
Welting									
Laces									
Filler									
TOTAL DIRECT FINDINGS									
INDIRECT FINDINGS									
TOTAL MATERIALS									
LABOUR—Cutting									
Fitting									
Lasting									
Making									
Tree & Packing									
Stock Fitting									
TIME WORK									
TOTAL LABOUR									
Machine Rents & Royalties									
Manufacturing Expense									
TOTAL FACTORY COST									
Administrative Expense									
TOTAL COST									
SELLING PRICE									
PROFIT OR LOSS									

Penny-Wise Accounting

By R. L. B. Joynt, C.A.

A Canadian case history

DURING recent months, accounting periodicals throughout United States and Canada have contained articles on an accounting practice which has been in actual use for well over two decades. Nevertheless, "cents elimination", or "whole-dollar accounting", or "penny elimination" are terms which are relatively unfamiliar to most accountants.

History of Cents Elimination

As early as 1928, Bethlehem Steel Company made no secret of the fact that it was trying out a "cents elimination" program in its accounting department to "simplify procedures and improve clerical effectiveness". Although the plan was successful from the start, there was no great enthusiasm shown over the new accounting find. Thirteen years later, in *The Journal of Accountancy,* November, 1951, Bethlehem Steel reviewed the benefits of this idea without causing any noticeable stir on the accounting horizon.

Not again until 1950 do we hear voices raised above a whisper in defence, or otherwise, of this accounting mechanism. At that time, Dravo Corporation of Pittsburgh began the practice of "penny elimination", as discussed by L. F. Adams, Auditor, in N.A.C.A. Bulletin, April, 1950. In subsequent articles and speeches, Mr. Adams proclaimed the merits of the idea and "after five months of this procedure" was "able to reduce clerical staff by approximately 9%".

In 1952, Arthur Young & Co., Certified Public Accountants, took particular interest in the subject. R. H. Birkhold, of their New York office, writes on the subject in *The Controller,* April, 1952, while in *Cost and Management,* January, 1952, R. C. Jordan, of their Milwaukee office discusses the same question. Incidentally, an up-to-date version of the Bethlehem Steel program may be found in the N.A.C.A. Bulletin, January, 1952, reprinted in *The Canadian Chartered Accountant,* June, 1952.

Early this year our company became interested in this accounting approach, somewhat oblivious at the time of the renewed interest in this subject. Now, after four months of actual operation, we have joined the small but well satisfied group of penny-wise accountants.

The "Rounding-out" Principle

As a general principle, the success of penny-wise accounting involves the elimi-

nation, or "rounding-out", of cents in all possible accounts — asset, liability, expense, revenue — at time of original entry, or earliest accounting stage possible. The exceptions, which it appears necessary to make, cover cash and bank, accounts receivable, and accounts payable, although even these exceptions need not be applicable to the balance sheet.

We tested methods of "rounding", and confirmed that the minimum variance is established as follows: reduce 49c and under; increase 51c and over; change 50c to nearest even dollar. Generally, this is the "rounding" method we have used, but we found it practical to make certain variations. One obvious problem is the handling of numerous individual and uniform items of less than $1.00. We were perhaps fortunate in encountering this situation early. For example, in the cafeteria, daily accounts for bread, milk, and some other supplies would have been considerably reduced by the usual "rounding". By accumulating these charges for one week and then rounding (and they are paid on a weekly basis), the difference was minimized.

Applications

Although the application of "pennywise" accounting must be tailored to the individual industry or operation, it may be of interest to discuss in some detail the methods we have adopted in the various accounting functions.

1. *Purchases*

We operate a voucher register on a National Cash Model 3000 Bookkeeping Machine, and enter all charges for which cash is disbursed. With the exception of the accounts mentioned previously, namely, cash and bank, accounts receivable, and accounts payable, all charges, including raw materials, expenses, capital assets, are distributed and "rounded" on the invoice in the one clerical operation. This "rounding" is first to the nearest dollar of the *invoice total*, and then worked back to the individual charges.

The machine entry has been—

CR. Accounts Payable, Cash Discount
DR. Distribution Charges
Depress "balance" key to clear.

The entry, with "cents-elimination", is identical, has no additional clerical operations. The only difference is that the "balance" key now prints the cents eliminated, which must be 50c or less. The operator readily grasped this principle and has had no difficulty maintaining operation speed. The "double-entry" principle is maintained in balancing the voucher register, by adding the cents column. Although there is no saving in balancing of totals, the distribution card totals, having over 26,000 entries in a year, now in dollars, can be posted and balanced more readily.

2. *Sales*

Tabulating cards are punched in dollars and cents from sales invoices, showing dealer total amount, sales tax, excise tax, and detail sales classifications.

We have not found it practical to punch sales classifications to the nearest dollar. The ease with which we are able to use cards punched in dollars and cents for various purposes appears to more than offset any savings in "rounding" at this stage.

First tabulating run for the month shows total charges for each dealer, analyzed by sales classes and sundry credits for the month, and year to date, for reconciliation with accounts receivable monthly dealer postings.

A duplicate of this run, filed by dealer, becomes the sales department dealer sales record.

A second run shows sales classifications for the period, tax accounts, and

sundry revenue accounts in dollars and cents. This is entered in the sales summary, with all revenue accounts rounded to the nearest dollar, but accounts receivable and tax accounts in dollars and cents. Any excess over $1.00 is adjusted to the major sales classification, and balance of cents entered in "cents-elimination" column.

3. *Payroll*

Office payroll on a weekly basis is relatively fixed, and cents-elimination is made at time of original distribution.

On the other hand, factory payroll, on an hourly or incentive basis, is calculated and distributed daily. Tabulating cards are punched in dollars and cents and accumulated on a weekly basis to arrive at weekly gross pay. These same cards are then sorted to provide the payroll expense analysis. At this stage, the report is in dollars and cents. First, departmental totals are rounded as they are machine totalled (no figures are actually changed) to arrive at payroll total. The difference between this figure and the actual payroll total is the cents-elimination amount. Next, departmental totals are split between indirect labour and direct labour. Detail indirect labour items are rounded as they are machine totalled (again no actual changes are made in the figures themselves) and the difference between this figure and departmental total is entered as direct labour. When the cost clerk posts the direct labour charges, he makes any adjustment necessary due to rounding. Previously both payroll analysis clerk and cost clerk had been totalling and balancing the direct labour charge.

4. *Inventories*

As pricing and extending of physical inventories are entirely accounting functions, it was relatively simple to arrange that extensions be made in "rounded" dollars. The same principle was applied to all book and perpetual inventory records. This represents a small but important saving as it coincides with the additional work at financial closing time.

Admitted to the Ontario Institute in 1933, Mr. R. L. B. Joynt, C.A. practised his profession for several years and in 1941 joined the Canadian Kodak Co. He is now comptroller of that company.

5. *Capital Assets and Depreciation Reserves*

It will now be apparent that the procedures outlined above will result in capital asset charges reaching the accounts in dollars. It is now also practical to make depreciation charges in dollars. At this stage, opening balances of assets and reserves, however, remained in dollars and cents. Although we do not consider that it is inherent to the success of the plan, we eliminated the cents from opening balances, by rounding off asset and reserve control accounts and following the process back to the detail accounts. This work was performed with a minimum of confusion and has definitely had the effect of cleaning-up and finalizing the job.

6. *Production Cost Records*

In a similar fashion, all information entered in the cost accounts now reaches that department in dollars. As we operate on year-to-date costs, it was relatively simple to eliminate the cents from opening balances.

In our company, we do a small amount of job costing and a large volume of process costing, as well as power house costing for electric current, refrigeration, and steam. Process costing and power costing involve various accumulations of figures, progressive distributions, and transfers. Errors at an early stage often

require hours to locate and adjust. Reduction in volume of figures (digits) handled is resulting in a definite saving of clerical time, as well as a reduction of errors.

It will thus be seen that in their entirety, cost records must now be in dollars. No entry in cents is accepted.

Gradual replacement and revision of cost forms will take advantage of this situation. Certain forms are already in operation which conserve space and reduce printing costs.

7. *Other Accounting Records*

Cash Receipts

Cash receipts are recorded daily in the cash receipts journal. Bank and accounts receivable are recorded in dollars and cents, but other revenue accounts and expense accounts are "rounded" when entered. In balancing totals, if the difference or penny-elimination amount does not exceed $2.00 for the 20 entries for the period, no further check is made.

General Journal

Each journal entry shows the cents eliminated when necessary. One must keep in mind that with most accounts in dollars the majority of journal entries now originate in dollars.

Inter-Departmental Requisitions

Inter-departmental requisitions are rounded in the usual manner. In the process, however, we found numerous small charges for stationery for less than 50c for which there would be no charge when "rounded". After studying this situation, we concluded that the total amount of this departmental charge was not significant, so, without making any change in authorization of issues, we discontinued pricing of stationery items entirely, and now allocate the original purchase to the section — office or factory — with greater usage.

Stores Requisitions

Stores requisitions are handled without any exception to the rounding. Although there are numerous issues of small value, such as nails, bolts, nuts, we recently instituted a practice by which items with average issues of less than $2.00 are expensed at time of purchase.

Inter-Company Billings

On inter-company charges to the parent company, items are rounded, and progress is being made on expanding the practice to other inter-company purchases and sales. No changes have been made in billing of sales of finished goods to associated companies.

8. *Balance Sheet*

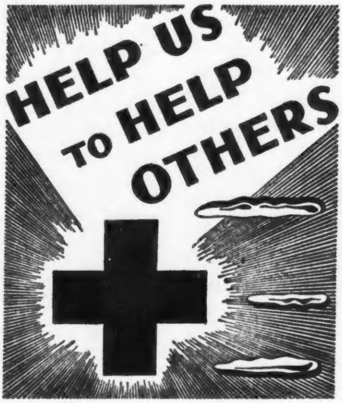
It will be evident the balance sheet will show cents because of the exceptions, unless some further provision is made. To secure uniformity, increase readability, and decrease typing, a post-closing entry is made reversing the cents showing on the balance sheet. This entry is reversed at the beginning of the next accounting year. On interim balance sheets the entry need only be a memorandum entry.

Disposition of the cents-elimination account itself is made by writing off the balance to administrative general expense. In four months the balance stands as $4.76.

Our company has made the changeover with a minimum of effort and confusion. Resistance to the change has largely been dissipated upon proper explanation of the objectives. In fact, there has been a certain change of attitude of all accounting personnel. Although this is an intangible, it is no less real and has acted as a stimulus to suggestions concerning other accounting practices.

Penny-wise accounting involves the consideration of the dollars and the elimination, without total disregard, of

the cents. In the same way that we have established the relative unimportance, or lack of necessity, of cents in our accounting practice, the savings realized are correspondingly small on individual items. In general and cost accounting, there are small labor savings. There are also small savings caused by reduction of clerical errors. We have also begun to revise certain of our forms which will result in small savings in printing and stationery costs, and in clerical time because of improved forms design. In the few months of operation, these individual savings are beginning to accumulate, and penny-wise accounting has lost its novelty to become firmly established in our accounting system.



A "SAMPLE" STORY

One day, in a train coach, an old cloak-and-suit traveller, homeward bound from a Western trip, sat beside a young, striking-looking man who, he afterwards learned, is a law professor in a university in Montreal.

The traveller tried to start up conversation but with little encouragement.

"Fine day," he ventured.

"Well, yes," said the stranger.

"Pretty good crops."

"Fair."

"Think we'll have a shower?"

"Don't know."

The traveller didn't give up, but all his questions begot monosyllables.

Somewhat provoked, he said at last, "What line are you in?"

"Brains," said the professor, briefly.

"Umph!" said the tired traveller, "lucky, isn't it, that you don't have to carry around any samples?"

—*Contributed by M. Goodman, Montreal*

Research Bulletin No. 9

THE USE OF THE TERM "RESERVE" AND ACCOUNTING FOR RESERVES

Bulletin No. 9 of the Committee on Accounting and Auditing Research of the Canadian Institute of Chartered Accountants issued January 1953

THE USE of the term "reserve" in a number of widely different senses has led to misunderstanding of financial statements. The Committee considers that the use of the term should be restricted so as to prevent such misunderstanding.

I. USE OF THE TERM

Present Use of the Term "Reserve"

In present practice the term "reserve" is used to describe such varied items as the following:

(a) A deduction made from the stated value of an asset to reduce it to the amount expected to be realized, e.g., "reserve" for doubtful accounts.

(b) A deduction made from the stated value of an asset to indicate the portion of the cost (or other book value) that has been charged to costs or expenses, e.g., "reserve" for depreciation.

(c) An estimate of sums payable in the future

- (i) where the exact amount to be paid is not known, e.g., "reserve" for salesmen's commissions, "reserve" for taxes,
- (ii) where the liability to pay is disputed, or
- (iii) in respect of probable further costs in connection with otherwise completed transactions, e.g., "reserve" for product guarantees.

(d) Amounts which have been received for services or goods to be supplied in the future, e.g., tickets sold by transportation companies, dairies, bakeries and amusement companies.

(e) Deposits received or charges made in connection with the shipment or sale of returnable containers.

(f) A variety of charges in the profit and loss account in respect of the creation of or addition to the "reserves" referred to above.

(g) An amount which though not required to meet a liability or contingency known or admitted or a decline in value which has already occurred as at the statement date, has been appropriated

- (i) at the discretion of management, e.g., reserve for future decline in inventory values, reserve for general contingencies, reserve for future plant extension, or
- (ii) pursuant to the requirements of a statute, the instrument of incorporation or by-laws of a company or a trust indenture, or other agreement, e.g., sinking fund reserve, general reserve, preferred stock redemption reserve.

Basic Concept of the Term "Reserve"

In its ordinary significance the term "reserve" is used as a verb to denote the act of setting something aside, or as a

noun to describe that which has been set aside or held back for a future or special use. In accounting the term may be considered as conforming to such meanings only where used to describe an appropriation of net profits or surplus but not where used to describe amounts which are required to be brought into account in the determination of net profit.

Conclusion

It is recommended:

(A) that the term "reserve" be not used to designate amounts provided in respect of actual liabilities, deferred income or diminutions in the values of assets such as are set out in items (a) to (e) inclusive on page 126 above, or the related charges, if any, in the profit and loss account, as referred to in item (f) above,

(B) that the term "reserve" be used only to designate amounts referred to in item (g) above, i.e., amounts appropriated from net profits or other surplus for purposes other than those set out in (A) that were provided either

(i) at the discretion of management or

(ii) pursuant to the requirements of a statute, the instrument of incorporation or by-laws of a company or a trust indenture or other agreement.

Accordingly the term "reserve" would be appropriate in connection with such items as:

- a general reserve,
- a general contingency reserve,
- a reserve for possible future decline in inventory values,
- a reserve for future plant extension, or
- a sinking fund or redemption reserve in connection with bond and stock issues.

Terminology Suggested to Replace Inappropriate Use of "Reserve"

The following suggestions are made for terminology to replace the present inappropriate use of the term "reserve" in the examples set out in items (a) to (f) on page 126.

(a) Where the term has been used to describe a deduction made from the stated value of assets to reduce them to the estimated realizable value it should be replaced by words properly descriptive of the nature of the deduction. For example, in the case of accounts receivable the amount of the deduction would be better described as "Allowance for doubtful accounts".

(b) Where the term has been used to describe a deduction made from the stated value of assets to indicate the portion of the value thereof which has been charged to costs and expenses, the accumulated amount would be better described as "Accumulated depreciation" or "Accumulated Allowance for Depreciation".

(c) If the amount of a liability can only be estimated at the statement date this fact may be indicated by employing words which are properly descriptive, e.g., "Estimated damages payable", "Income taxes payable (estimated)". Where the existence of a liability is itself in doubt, that fact may also be indicated, e.g., "Taxes assessed but disputed". Where there is a reasonable likelihood that liabilities will arise or losses be incurred in respect of past transactions, an adequate indication of the circumstances may be furnished, e.g., "Possible claims under product guarantees".

(d) Receipts for services or goods to be supplied in the future may be appropriately described, e.g., "Tickets outstanding", "Services paid for in advance".

(e) A variety of circumstances will be found in connection with returnable

containers and the appropriate wording should have regard to these factors. In the case of deposits received the liability account may be described as "Container deposits refundable".

(f) In the profit and loss account charges in respect of certain of the above items may be described as:

(i) Allowance for doubtful accounts,
(ii) Depreciation or allowance for depreciation,
(iii) Taxes on income or estimated taxes on income.

II. ACCOUNTING FOR RESERVES

In the past a number of reserves (using the term in the sense recommended herein) were created or increased by charges in the profit and loss account which reduced what would otherwise be the stated net profit for the year.[1] Even though these reserves were created in such fashion, charges should not now be made against them which would relieve the profit and loss account of charges that should properly be taken into account in determining the net profit or loss for the year. These reserves can only be regarded as discretionary appropriations from earned surplus and should be reduced by transfers to the earned surplus account.

Conclusion

It is recommended that reserves should be created or increased only by appropriations of net profits or surplus and that all reductions in reserves should be returned to surplus. Reserves should not be set up or increased by charges made in arriving at the net profit for the year nor should any charges be made against the reserve accounts which would relieve the profit and loss account of any charge that would otherwise be made against it.

Since reserves are segregations of earned surplus it is desirable that they be shown on financial statements as constituting part of the shareholders' equity.

[1] During World War II the Excess Profits Tax Act permitted the deduction of certain inventory reserves. Many companies created these reserves by charges against income since they resulted in large tax reductions and in these circumstances the creation of the inventory reserves from earned surplus would have distorted the income account. Subsequently the necessity for a clearer delineation between amounts required for a proper determination of income and discretionary reserves has become more apparent; also new accounting practices have been developed to overcome, through allocation of income taxes, the distortion caused when large charges to earned surplus result in substantial savings in the current year's taxes.

DR. WILLIAM CLIFFORD CLARK

On learning of the sudden and much regretted death of Dr. William Clifford Clark, Deputy Minister of Finance, several readers have recalled the fact that he was largely responsible for preparing the original Queen's Course of Instruction which the Ontario Institute adopted in January 1922. This course has since been employed in some measure by all ten Institutes and has become the standard course used by most of them.

Accounting Research

Reports of Studies by
The C.I.C.A. Research Department

AN ANALYSIS OF PRESENTATION TECHNIQUES IN ANNUAL FINANCIAL REPORTS

THE research staff of the Canadian Institute of Chartered Accountants has analyzed the published financial statements and reports of a group of Canadian industrial and mercantile companies. This survey was undertaken in an endeavour to bring to light any significant trends in statement presentation and in accounting principles in this country, which are considered either good or bad. In addition it will assist the Research Committee of the C.I.C.A. to discover to what extent their recommendations are being adopted and the matters which are creating problems in statement presentation.

The survey of the 1951 financial statements was expanded to include 279 companies as opposed to 209 for 1950 and 202 for 1949. Approximately 100 additional reports were informally reviewed for 1951 and any irregularities or inconsistencies noted. The companies included in the detailed analysis represent the following industries — beverage, construction, merchandising, foodstuff, iron and steel, pulp and paper, textiles, and sundry processing and distributing.

The Committee on Accounting and Auditing Research believes that the presentation of information of this nature may be helpful to members and students, and further analyses of certain features of statement presentation will be published in *The Canadian Chartered Accountant* from time to time.

Accounts Receivable

Disclosure of Doubtful Accounts

Of the 1951 financial statements analyzed, 140 indicated that provision had been made for uncollectible accounts, but the exact amount of the provision was not disclosed.

Those statements which did set out the amount of the provision disclosed it as follows:

45—as a deduction from trade accounts receivable;

40—in the description of the trade accounts receivable;

3—as a reserve on the liability side of the balance sheet.

Fifty-one made no reference to uncollectible accounts.

Terminology re Allowance for Doubtful Accounts

The indiscriminate use of the term "reserve" in a number of widely different senses has often led to misunderstanding of financial statements. There has been a general trend among accounting societies to limit the use of this term in order to avoid confusion. The term "allowance" has been recommended when considering the question of doubtful debts. To date, however, the officers of Canadian companies adhere to their preference for the term "reserve".

The following breakdown of the terminology used in the 1951 financial

MARKETABLE SECURITIES

1951	1950	1949	
72	61	56	Basis of valuation shown — market value shown
42	28	27	" " " not shown — market value shown
14	16	12	" " " shown — market value not shown
7	8	6	Neither shown
1			Basis of valuation shown — reference to "market"
136	113	101	
143	96	101	No marketable securities
279	209	202	

Fig. 1

statements corroborates this point:

191 — reserve
23 — provision
11 — allowance
2 — estimated
1 — amounts set aside to take care of.

Marketable Securities

Basis of Valuation and Market Value

(See Fig. 1)

Bulletin No. 1, issued by The Committee on Accounting and Auditing Research of the Canadian Institute of Chartered Accountants, states that "the basis of the carrying value of these securities — say, cost — should be stated as well as the quoted market value".

Cost is the general basis of valuation adopted by Canadian companies. A variety of other bases such as — "less reserve", "par", "cost and realizable value", "cost less reserve", "cost less write off", "cost or less", "not in excess of market", "market" and "book value" are also found.

Inventories

Basis of Valuation

(See Fig. 2)

"The basis of pricing of inventories should be clearly disclosed" (Bulletin No. 1, p. 3).

The majority of the companies adhered to the policy of disclosing the basis of pricing inventories, although a few failed to set out this information on their financial statements (8 in 1949, 10 in 1950, and 16 in 1951).

The "lower of cost or market" appears to be the generally accepted basis of inventories in this country.

The miscellaneous bases of valuation include— "not exceeding manufactured or purchased cost", "not more than the lower of cost or market", "cost or under", "cost or under — not more than market", "market", "standard cost", "approximate cost", "estimated cost", and "not more than cost".

Many of the descriptions of the basis of inventory valuation tend to confuse rather than to aid the reader

INVENTORIES

1951	1950	1949	Basis of Valuation
62.7%	58.7%	60. %	Lower of cost or market.
10. %	15.2%	9.3%	Cost, factory cost, production cost.
27.3%	26.1%	30.7%	Miscellaneous.

Fig. 2

of the financial statements. The following descriptions give no information: "Valued on a conservative basis and not over replacement value", "Valued at cost or market value", "Valued at cost or lower but not exceeding market value", "Valued at cost or lower", "Valued by responsible officials of the company".

The reader of these financial statements is merely given a clue and, if interested, must pursue the matter further to find out exactly what is meant. There is the possibility, however, that such descriptive terminology is used in some cases to describe a basis of valuation such as "retail inventory".

Little or no reference has been made in the published financial statements to the methods used in determining inventory "cost".

Determination and/or Certification of Inventory Figure

The responsibility for and the establishment of inventory figures was as shown in Fig. 3.

The miscellaneous descriptions include: "determined by physical count", "based on company's records", "based on company's records and physical count", "in accordance with the company's usual practice as to quantities and value", "as approved by management and/or officials of the company", etc.

Inventory Reserves

The usual underlying purpose in setting up inventory reserves, namely, to provide for future price uncertainties, is not always disclosed in the description of such reserves in the financial statements. In many instances they are merely referred to as "inventory reserves". Of the inventory reserves indicated in the 1951 financial statement, 41% were shown on the liability side of the balance sheet; 14 were set out as a deduction from the current assets; 6% were set out in the description of the inventory figure; 29% were merely referred to as "less reserve" in the description of inventory valuation.

RESPONSIBILITY FOR INVENTORY FIGURES

1951	1950	1949	
37. %	41. %	42. %	as determined and certified by management and/or officials of the company
11.1%	11. %	15. %	as certified by management and/or officials of the company
3.7%	3. %	5. %	as determined by management and/or officials of the company
4. %	5. %	3. %	as certified or determined by management based on physical count
7.2%	11. %	10. %	miscellaneous
63. %	71. %	75. %	
37. %	29. %	25. %	not stated

Fig. 3

A Recent Book

How to Prepare Your Income Tax, by Lancelot J. Smith, F.C.A.; published by Wm. Collins Sons & Co. (Can.) Ltd., Toronto; pp. 164 and index; price $1.50

The 1953 edition of this excellent and well-known book reflects the changes in the law, the promulgation of regulations, and the decisions of the courts and of the Appeal Board during the past year. Although still designed as a handbook for the individual taxpayer, it also covers in detail topics, such as capital cost allowances, which are of paramount interest to corporations.

J. V.

STANDING AND SPECIAL COMMITTEES OF THE C.I.C.A. 1952-53

The following additions have been made to standing and special committees of the C.I.C.A. since the publication of the White Book:

Board of Examiners-in-Chief for 1953 Examinations

IAN BELL, British Columbia

Sub-Committee on Courses of Instruction

H. C. DELL, Ontario (*Chairman*)
A. G. BURTON, Alberta
G. A. CHAMBERS, British Columbia
DANIEL SPRAGUE, Manitoba
G. A. OULTON, New Brunswick
H. J. MCDOUGALL, Newfoundland
C. W. GURNHAM, Nova Scotia
MRS. E. P. MACPHERSON, P.E.I.
C. D. MELLOR, Quebec
H. S. MOFFET, Saskatchewan

Public Relations Panel

L. E. PEVERILL, Nova Scotia
ROSAIRE COURTOIS, Quebec
L. E. FINGARSON, Saskatchewan

Recruitment and Training for Accounting Personnel

T. C. KINNEAR, Toronto (*Vice-Chairman*)
J. C. TAYLOR, London

Professional Notes

President's Tour of the Western Institutes

Mr. Lorn McLean, president of the C.I.C.A., accompanied by Mrs. McLean and Mr. Clem King, secretary and research director, visited the four Western provincial Institutes in January.

In Edmonton

Mr. McLean and Mr. King discussed questions of common interest with the Edmonton members of the Alberta Institute's Council. At a dinner meeting on Monday, January 15, Mr. McLean presented certificates of membership to the new members who had been successful in the October 1952 examinations. He then spoke to the group on the profession, outlining the problems that faced those in public practice and those in administrative practice. Mr. King spoke on the functions of the C.I.C.A.

In Calgary

At a dinner meeting on January 13 Mr. McLean presented certificates to successful candidates from the Calgary area, and both he and Mr. King addressed the meeting. Following the meeting, Mr. and Mrs. R. E. Waller entertained the visitors and members of Council and the executive of the Calgary C.A. Club.

On Wednesday, January 14, the wives of members of the Calgary C.A. Club gave an afternoon tea in honour of Mrs. McLean. Mr. McLean and Mr. King met with the Calgary members of the Alberta Institute's Council.

In Regina and Saskatoon

Both Mr. McLean and Mr. King spoke to the Regina C.A. Club, and Mr. McLean presented certificates to the newly admitted members. On January 16 and 17 they conferred with the Council members of the Saskatchewan Institute in Regina and Saskatoon. After watching the Saskatoon Quakers emerge victorious over their opponents on Saturday, January 17, the visitors, along with Council members and the Saskatoon C.A. Club executive and their ladies, were entertained at an informal buffet supper by Mr. and Mrs. G. G. Patrick.

In Winnipeg

While Mr. McLean and Mr. King met with the Council of the Manitoba Institute on Monday, January 19, the wives of the Manitoba Council members entertained Mrs. McLean at luncheon at the Manitoba Club.

In Vancouver

The next day found the visitors in Vancouver where Mr. McLean and Mr. King held a meeting with the Council of the B.C. Institute. On Wednesday, January 21, Mr. McLean addressed the 1952 graduating class of the Institute and presented membership certificates to the 45 new members. He also presented the C.I.C.A. silver medal for the highest standing in the 1952 intermediate examination to Mr. W. J. Misener of Vancouver. At a dinner meeting of the B.C. Institute that evening Mr. McLean and Mr. King spoke to the members on the work and functions of the C.I.C.A.

ALBERTA

Mr John B. Whyte, C.A. announces the opening of an office for the practice of his profession at 10168 105 St., Edmonton.

* * *

Mr Arthur Maw, C.A. announces the admission to partnership of Mr M. L. Devonshire, B.Com., C.A. Henceforth practice of the profession will be conducted under the firm name of Maw, Devonshire & Co., Chartered Accountants, with offices at 405-411 Maclean Bldg., Calgary.

BRITISH COLUMBIA

Mr John C. Oswald, C.A. announces the admission to partnership of Mr P. G. Blades, C.A. Henceforth the practice of the profession will be carried on under the firm name of John C. Oswald & Co. with offices at 207 W. Hastings St., Vancouver.

Messrs Herbert J. Paisley, C.A., W. L. C. Wallace, C.A., A. F. Sinclair, C.A., and W. R. Hollingshead, C.A., formerly practising under the name of Herbert J. Paisley & Co., announce a change in the firm name to Paisley, Wallace & Co., Chartered Accountants, with offices in Vancouver, Prince George, and Quesnel.

* * *

Messrs W. Russell Watson, C.A. and John B. Ewing, C.A. announce the admission to partnership of Mr Dale L. Rumball, B.Com., C.A. Practice of the profession will henceforth be carried on under the name of Watson, Ewing & Rumball, Chartered Accountants, with offices at 602 W. Hastings St., Vancouver.

B.C. Students Society

The recently elected executive of the Institute of Chartered Accountants of British Columbia Students' Society for 1953 are as follows: *president,* B. Fahy; *vice-president,* A. Jones; *secretary,* David N. Ker; *treasurer,* Howard B. Karras; *education committee chairman,* B. Sproule; *entertainment committee chairman,* Ian Adam; *second year rep.,* A. Coles; *first year rep.,* P. C. Barter.

MANITOBA

William Young & Co., Chartered Accountants, announce the removal of their offices to Bank of Canada Bldg., Portage East at Rorie, Winnipeg.

NEW BRUNSWICK

Mr G. K. McKenzie, C.A. announces the opening of an office for the practice of his profession at 366 Douglas Ave., Saint John.

* * *

Hudson, McMackin & Co., Chartered Accountants, announce the admission to partnership of Mr W. M. G. Allwood, C.A. He will be resident partner at their Fredericton office.

* * *

Mr Randolph E. Cox, C.A. announces the admission to partnership of Mr T. J. Hammett, C.A. Henceforth practice of the profession will be carried on at 19 Market Sq., Saint John, under the firm name of Cox & Hammett, Chartered Accountants.

Mr Lyman M. Robinson, C.A. announces the opening of an office for the practice of his profession at 63 Crown St., Saint John.

ONTARIO

Miss Gwendolyn C. Conmee, C.A. announces the opening of an office for the practice of her profession at 11 King St. W., Toronto.

* * *

Mr Nathan Freeman, C.A. announces the removal of his offices to 858 Eglinton Ave. W., Toronto.

* * *

Arthur A. Crawley & Co., Chartered Accountants, announce the admission to partnership of Mr Lloyd A. Bellamy, C.A. Mr Bellamy will be resident partner of their Sudbury office.

* * *

Mr Harold M. Chapman, C.A. announces the removal of his office to 330 Palmerston Blvd., Toronto.

* * *

Peters, Brown & Good, Chartered Accountants, announce the retirement from partnership of Mr Harvey L. Good, C.A. Henceforth practice of the profession will be conducted under the firm name of Peters, Brown & Co., Chartered Accountants, with offices at 159 Bay St., Toronto.

Ontario Students Association

The Students Association of the Institute of Chartered Accountants of Ontario held a dinner meeting and business equipment show on January 6 at the Oak Room of the Union Station. One hundred and fifty members and guests attended. After dinner the group was divided into seven sections and each section witnessed 20-minute demonstrations by a number of business equipment manufacturers.

* * *

Mr M E. Duckman, C.A. announces the admission to partnership of Mr. D. Resnick, C.A. Henceforth practice of the profession will be conducted under the firm name of Duckman, Resnick & Co., Chartered Accountants, 430 King St. W., Toronto.

QUEBEC

M. Real Dubois, M.Com., C.A., announces the opening of an office for the practice of his profession at 580 16th Ave., Lachine.

* * *

M. Gerard Renaud, M.Sc.C., C.A. announces the opening of an office for the practice of his profession at 267 St. Paul St., Quebec City.

Quebec Students Society

Mr J. R. Heron, public relations adviser of the Royal Bank of Canada, addressed the December dinner meeting of the Chartered Accountants Students' Society of Quebec. He spoke on "The Qualities and Organization Required in an Executive". Mr Peter Leggat presided and Mr Peter Aird thanked the guest speaker.

SASKATCHEWAN

Mr Walter C. Jeffery, F.C.A., announces the admission to partnership of Mr Chester A. Jeffery, B.Com., C.A. Henceforth practice of the profession will be carried on under the firm name of Jeffery & Jeffery, Chartered Accountants, at Weyburn.

* * *

R. L. Bamford & Co., Chartered Accountants, Moose Jaw and Estevan, announce the opening of a branch office in Assiniboia.

News of Our Members

Mr William A. Arbuckle, C.A. (Que.) has been appointed a director of the Royal Trust Company.

* * *

Mr K. G. Blackader, C.B.E., D.S.O., M.C., E.D., C.A. (Que.), has been named chairman of a committee of Montreal accountants formed to study the finances of the three teaching hospitals affiliated with McGill University.

* * *

Mr K. LeM. Carter, F.C.A. (Ont.), was guest speaker recently at a meeting of the Ottawa Chapter of the Society of Industrial and Cost Accountants. He spoke on the fluctuations in the value of the Canadian monetary unit.

Mr Gordon W. Hunter, C.A. (Man.), has been appointed financial adviser to the Defence Production Department of the Government of Canada. Mr W. H. Huck, C.A. (Ont.), will be Mr. Hunter's deputy.

* * *

Mr G. Douglas Morrell, C.A. (Que.), has been elected a director of Duplan of Canada Ltd., Montreal.

* * *

Mr Paul D. Shannon, C.A. (Man.), has been appointed controller of Royal Victoria Hospital, Montreal.

* * *

Mr R. B. Simpson, C.A. (Man.), has been appointed comptroller of General Steel Wares Limited, Toronto.

Obituaries

Frederick Clarence Hurst

It is with deep regret that the Institute of Chartered Accountants of Ontario announces the death of Frederick Clarence Hurst on February 2, 1953, at his home in Toronto. Mr. Hurst was senior partner of Gunn, Roberts & Co., Chartered Accountants, and a past president of the Institute. For a number of years he was treasurer of the Canadian Institute of Chartered Accountants. Born and educated in Toronto, Mr. Hurst became a student-in-accounts with Gunn, Roberts & Company in 1911. When he passed his intermediate examination, he was awarded a scholarship, and in 1915 he became a chartered accountant. He served

the Institute in many ways and in 1934 was elected a Fellow for distinguished services to the profession.

Mr. Hurst was superintendent of the Sunday School at St. Anne's Anglican Church. Latterly, he was a member of Grace Church-on-the-Hill, where he served as people's warden and had been chairman of the advisory board. He was keenly interested in the Boy Scout movement and, as Chairman of the Toronto Metropolitan Area Camp Committee, had done much in the development of Camp Kennabi in Haliburton. He was also a past president of the Toronto Field Naturalists Club and a member of the Federation of Ontario Naturalists.

To his wife and family, the members of the Institute extend sincere sympathy.

Sholto Cromarty Scott

It is with deep regret that the Institute of Chartered Accountants of Ontario announces the death of Sholto C. Scott in Toronto on February 1, 1953. Born in Penarth, South Wales, of Scottish parents, Mr. Scott was educated at Clifton College Bristol and Cardiff University, Wales. He became a member of the Institute of Chartered Accountants in England and Wales in 1908. Coming to Canada in 1911, he joined the audit office of the City Hall in Toronto and was appointed city auditor in 1919, a position he held until his death.

Mr. Scott joined the Institute of Chartered Accountants of Ontario in 1918. He was a member of Grace Church-on-the-Hill and served on the advisory board and was a former people's warden. He was a lay delegate to the Anglican synod.

To his wife and family, the Institute extends sincere sympathy.

Cecil Peter DeRoche

The Institute of Chartered Accountants of Saskatchewan announces with sincere regret the sudden passing of Cecil Peter DeRoche at the age of 47.

Mr. DeRoche was born in Saskatchewan and received his education in Saskatoon, graduating from the University of Saskatchewan in 1929 with the degree of Bachelor of Accounting. He was admitted to the Institute in 1931 and was an active member in the Institute until his death. He served on Council for ten years and was president of the Institute for the year 1942-1943. In recognition of his valued service to the Institute, Mr. DeRoche was made a Fellow in 1944.

"Cec." as his many friends knew him was widely known, both through his professional work and through his activities in hockey. He was an ardent hockey fan and at the time of his death was president of the Saskatoon Quaker Hockey Company Limited. Mr. DeRoche was a member of the Saskatoon Club, was a Rotarian and took a keen interest in the community life of Saskatoon.

To his wife and family the members of the Institute extend their deepest sympathy.

James William Westervelt

The Institute of Chartered Accountants of Ontario announces with deep regret the death of James William Westervelt, one of its oldest members, on December 19, 1952.

Mr. Westervelt was born in Brampton, Ontario and was educated in Woodstock and London. He was admitted to membership in the Ontario Institute on June 27, 1902. During his long professional career he displayed an active interest in business educational activities and for a time lectured at the University of Western Ontario. In 1950 he was elected a Fellow of the Ontario Institute.

To his wife and many friends, the members of the Institute extend their sincere sympathy.

Arthur R. Halladay

The Institute of Chartered Accountants of Ontario announces with deep regret the death of Arthur R. Halladay in Toronto on December 19, 1952. A life-long resident of Toronto, Mr. Halladay graduated in Commerce and Finance from the University of Toronto in 1930. After leaving university, he joined the staff of the Lumbermen's Mutual Casualty Company and became office

manager. Later he became a student-in-accounts with Vigeon & Company and was admitted to the Ontario Institute in 1942. A short time later he opened an office and continued to practice his profession until shortly before his death.

Mr. Halladay was one of the founders of the Diabetic Association of Ontario, a member of the Phi Kappa Sigma Fraternity, and of the Granite Club.

To his wife and children, the Institute extends its sincere sympathy.

A Letter from a Reader

CHEQUE STAMPS

Trail, B.C., Nov. 18, 1952

Sir: A small change in the excise tax regulations with respect to cheques and other bills of exchange would go a long way towards offsetting some of the extra work which has been thrust upon Canadian business during the last ten years or so by such statutory requirements as the deduction of income tax and unemployment insurance.

It is interesting to note that if one tax were substituted for the present 3c and 6c tax, cheques could be pre-stamped at time of printing with the following savings:

(a) All the recurring work involved in purchasing and affixing stamps would be automatically eliminated.

(b) Filing space for cancelled cheques would be automatically reduced and cheques would not be thrown out of line by the thickness of the stamps.

(c) Paper could be saved because pre-stamped cheques would not be so happily destroyed or used as scratch pads.

(d) The issuance of mechanically-signed cheques could be speeded up considerably by the elimination of the variable tax bottleneck, particularly where cheques are issued by mechanical tabulation (punched card system).

(e) The nuisance involved in the practice of issuing cheques without stamps or with the amount of the tax added to the face value would be eliminated.

The setting of a single tax would also make practicable a statutory requirement that all cheques be pre-stamped. This would not mean that banks would necessarily have to tie up any more working capital because they could sell cheque books on a consignment basis. The amount tied up should in fact be lessened because it is certain that fewer cheque forms would be consumed and fewer would be held in stock by customers.

Even though pre-stamped cheques sold by the banks would involve additional work in the custody of and accounting for cheque books, it is probable that this would be offset by the saving in cheque forms, the elimination of recurring routine work in handling the large number of cheques which are presented without stamps, and also elimination of the present work involved in the custody and accounting for stamps.

While it is not necessarily so it is true that some forgeries are perpetrated on the spur of the moment because cheque forms are so easily obtainable, and it is reasonable to assume that greater care in the custody of cheque forms might well lessen the temptation to commit fraud.

E. G. RANDALL,
Assistant Comptroller,
Consolidated Mining and Smelting Co. Ltd.

EDITOR'S NOTE: *Mr. Randall has obtained more than he wanted. On February 19 the Finance Minister recommended the outright repeal of the stamp tax. Much of what Mr. Randall says remains true, however.*

The Students' Department

J. E. Smyth, C.A., Editor

NOTES AND COMMENTS

TO the bystander one of the exciting things that can happen in the financial world is a proxy battle — the more exciting because it is a rare phenomenon. For the participants themselves, the proxy battle can be exhausting, deplorable, and embittering.

Charles M. Williams provides some lively reading on this topic in his book "Cumulative Voting for Directors" (Division of Research, Graduate School of Business Administration, Harvard University, Boston, 1951). He refers of course to proxy battles in U.S. companies but doubtless his observations are valid for Canada. Certainly they are of interest.

The experience seems to show that the state of mind of the average shareholder caught in the turmoil of a proxy battle is appropriately described by using the slang expression, "He doesn't know what the score is." Such a state of affairs means that proxy battles are likely to be fought not on the actual financial issues at stake but rather on emotional or moral issues. A proxy campaign must have "shareholder appeal" to succeed. Professor Williams cites the example of an important company in which "a dispute grounded in important policy issues culminated in a proxy fight in which members of the opposition succeeded in gaining sufficient proxies to overturn the management by focusing their attack on a generous retirement plan for the president, arguing that it represented unconscionable overreaching at the expense of stockholders." (page 80)

* * * * *

Further proof of the state of mind of many shareholders is found in the fact that shareholders frequently give proxies to *both* sides — like the good-natured fellows they are, only trying to co-operate! Professor Williams writes, " . . . the frequent vacillation by shareholders has made it a major point of tactics in proxy battles to press for the last-dated proxy, since the most recent supersedes earlier proxies." (page 77). His account of one incident in a proxy battle is especially memorable:

> Perhaps the ultimate case of indecision occurred in an Ohio contest. The sides were very evenly matched and it chanced that the shares held by a widow appeared decisive. She responded to the solicitors for one side with a proxy. To their dismay they learned at the meeting that she had changed her mind and given the opposition a later proxy. Soon after, however, they discovered that she had come to the meeting, and there they pleaded their case so effectively that she was won back to their side. When the opposition learned of that change they rushed up to the woman to prevail upon her to change her mind once more. After a few minutes of their impassioned argument, the widow suddenly burst into tears, and finally had to be led from the room in a state of hysteria. The side with her last proxy won the day. (p. 77)

The important emotional element present in proxy battles tends to create the illusion in the minds of many that *one* side *or* the other is selfishly thinking only of its own interest. The truth is likely to be, however, that *all* the active participants are seeking either to maintain or promote their own interests. When one gets right down to it, it is difficult to think of any purely "unselfish" motive which would get a person involved actively in a proxy battle. The word "selfish" as used in relation to matters of finance is itself emotional.

* * * * *

The book by Professor Williams is timely reading because of the proposed new Ontario Companies Act which contains a provision for cumulative voting for directors. If passed by the Ontario legislature it will be the first time cumulative voting has been recognized in Canada. In the United States there are presently 21 states which require a provision of cumulative voting (including California, Illinois, Michigan, and Ohio). The method was first suggested in Illinois in 1870. The proposed section for the new Ontario Act reads,

> 57.—(1) At every election of directors every shareholder entitled to vote has the right to cast a number of votes equal to the number of votes attached to the shares held by him multiplied by the number of directors to be elected and may cast all such votes in favour of one candidate or distribute them among the candidates in such manner as he sees fit.
>
> (2) Where a shareholder has voted for more than one candidate without specifying the distribution of his votes among such candidates, he shall be deemed to have divided his votes equally among the candidates for whom he voted.

A PUZZLE FOR MARCH

Mr. Johnson, being absent from home for a few days, incautiously left a box of a hundred cigarettes in his study. He also left two sons, Harold and Egbert, on the premises.

Harold discovered the cigarettes and filled his case, and soon afterwards, Egbert did likewise. At various times they replenished their cases till, after they had made seventeen such visits between them, they had emptied the box. Harold's case held three more cigarettes than Egbert's.

How many cigarettes did each take?

(Contributed by Mr. L. J. Upton, Toronto)

SOLUTION TO THE FEBRUARY PUZZLE

Let "x" = John's actual salary.

Then,

$x + (x + 300) + (x + 600) + (x + 900) + (x + 1{,}200) = 18{,}000 - 5{,}010$

$5x + 3{,}000 = 18{,}000 - 5{,}010$

$5x = 9{,}990$

$x = \$1{,}998$ per year (or \$166.50 per month)

AN ACCOUNTING TEASER

How can merchandise held for resale contribute to revenue without being sold? (If you cannot think of an answer see the last page, after the problems and solutions)

PROBLEM 1

Final Examination, October 1951

Auditing I, Question 8 (10 marks)

In a medium-sized manufacturing company you have always found the system of internal control relatively ineffective. As part of your audit program, carried out after the fiscal year end, you examine the transactions for four months selected by you.

On your arrival, the cashier explains to you that the cancelled cheques for the first six months of the year were accidentally burned when old records were being destroyed.

Required:

Outline the changes you would make in your audit program in view of this situation.

A SOLUTION

(1) Discuss the situation with the president or general manager to arrange for a necessary extension of procedures and to assure against a recurrence.

(2) Add the cheque column in the cash disbursements book, and post to Bank account in the general ledger for the six month period.

(3) Add the cash receipts column in the cash book, and post to Bank account in the general ledger for the six month period.

(4) Secure bank statements for the six month period directly from the bank, or check the clients' copies to the bank records.

(5) Check the cheques as recorded in the cash disbursements book to the bank statement and check the deposits to the bank statement for the six month period, noting particularly all items other than deposits or cheques.

(6) Reconcile the bank account as at end of the six month period.

(7) Examine vouchers covering disbursements for the six month period and check them to the cash disbursements book. Scrutinize vouchers and the cash disbursements book for the remainder of the year for unusual items and ascertain that no items that were set up in the first six months are set up again the second six months.

(8) Scrutinize the journal and debit and credit notes for the six month period for unusual items.

(9) If the auditor is very concerned, he may send out requests of verification of receipt of cheques to some of the suppliers, and confirm the accounts payable as at the year end.

PROBLEM 2

Final Examination, October 1951

Auditing II, Question 4 (15 marks)

The B Insurance Co. has asked CA to make an examination of the books and records of C Co. Ltd. to ascertain the amount of inventory loss suffered by reason of a burglary on 21 Sept 1951. Perpetual inventory records are not maintained. The company's fiscal year end is 30 June.

Required:

Outline the procedures CA should follow.

A SOLUTION

THE B INSURANCE CO.

Procedures for Ascertaining Amount of Inventory Loss

21 Sept 1951

(1) If CA is the regular shareholders' auditor, then the inventory as at 30th June can be accepted as the starting point. If CA is not the shareholders' auditor, then he must satisfy himself that the inventory figure as at 30th June is accurate and determine the basis of valuation.

(2) Test check purchase invoices and supporting evidence to the purchase records for the period from 1 July 1951 to 21 Sept 1951 to learn whether the internal control is adequate and whether purchases are being properly recorded and placed in warehouse stock.

(3) Test check sales invoices and supporting evidence to the sales record for the period from 1 July 1951 to 21 Sept 1951 to learn whether the internal control is adequate and whether sales are being properly recorded and deleted from warehouse stock.

(4) Test check debit and credit notes for the period from 1 July 1951 to 21 Sept 1951 to learn whether returned purchases and sales have been treated correctly.

(5) Scrutinize the purchase journal, sales journal, debit and credit notes and general journal for the period not checked in detail to uncover any unusual or incorrect allocations. Add these records in detail for the period and post to the general ledger. Add the general ledger accounts for purchases, sales, returned purchases and sales.

(6) Attend at physical stocktaking on 22 Sept or, if not possible at that date, then at a later date, and reconcile amount back to 22 Sept.

(7) Value the physical inventory on a basis comparable with the 30 June inventory; or if done by the client, check the client's valuation. Check additions, etc. of inventory.

(8) Check in detail purchases and sales invoices for 20, 21, 22 and 23 of Sept with all supporting evidence (receiving slips, shipping orders, purchase orders, etc.) in order to ensure the proper inventory cut off.

(9) With reference to past years' statements and current pricing policy in the business, establish the average gross profit percentage for this business.

(10) Apply the gross profit percentage to sales less returned sales for the period and determine the cost of goods sold.

(11) From the figures for cost of goods sold, total purchases during the period, and inventory as at 30 June, calculate what the inventory should have been as at 21 Sept.

(12) Compare this figure with the actual physical inventory [(6) and (7)] and the difference is the estimated loss by burglary.

PROBLEM 3

Final Examination, October 1951

Auditing III, Question 2 (25 marks)

You have been assigned to the audit of the accounts of X Co. Ltd. for the year ended 31 Dec 1950 with the suggestion that you study the following summarized financial statements of the company before starting to plan your audit program:

X CO. LTD.

BALANCE SHEET

as at 31st December

ASSETS

	1950	1949
Bank	$ 45,200	$ 4,300
Accounts receivable	628,100	413,700
Inventories	821,000	392,200
Marketable securities	10,000	335,000
Land — at cost	102,800	53,600
Buildings and machinery — at cost	628,500	611,200
Furniture and equipment — at cost	74,800	98,800
	$2,310,400	$1,908,800

LIABILITIES

	1950	1949
Trade creditors	$ 288,600	$ 279,100
Reserve for bad debts	21,000	21,000
Accrued liabilities	29,000	61,000
Accrued taxes	81,000	44,000
Bonds outstanding	400,000	....
Reserves for depreciation		
Buildings and machinery	157,300	117,600
Furniture and equipment	28,000	24,400
Common stock	800,000	700,000
Preferred stock	....	300,000
Surplus	505,500	361,700
	$2,310,400	$1,908,800

OPERATING STATEMENT

	1950	1949
Sales	$1,411,100	$1,095,400
Cost of goods sold	1,140,500	827,000
Gross profit	$ 270,600	$ 268,400
Selling expenses	$ 66,500	$ 48,700
Administration expenses	90,000	64,500
	$ 156,500	$ 113,200
Net operating profit	$ 114,100	$ 155,200

Investment income	12,500	32,500
	$ 126,600	$ 187,700
Income tax	41,000	75,000
Net profit — carried to surplus	$ 85,600	$ 112,700

SURPLUS ACCOUNT

Balance at 31 Dec 1949		$ 361,700
Add prior year tax adjustment	$ 7,200	
profit for 1950	85,600	
profit on sales of securities	300,000	392,800
		$ 754,500
Less dividends paid		249,000
Balance at 31 Dec 1950		$ 505,500

Required:

As a result of your analysis of the above statements, set out the items to which you would direct particular attention during your audit, giving in each case the reasons why special attention would be necessary.

A SOLUTION

X CO. LTD.

ITEMS REQUIRING PARTICULAR ATTENTION DURING THE AUDIT
for the year ended 31 Dec 1950

(1) Accounts receivable

- (i) Have increased approximately 50% in 1950; sales have increased 30% in 1950.
- (ii) Represent approximately 5 months' sales in 1950. This raises a question about the collectibility of the accounts.
- (iii) The reserve for bad debts is unchanged. In view of the increase in the outstanding accounts it seems improbable that the estimated uncollectible amount should remain the same.

(2) Inventories

- (i) Have increased approximately 100% in 1950 although sales have increased only 30%.
- (ii) Represent approximately 8 months' supplies in 1950 as compared with 6 months' in 1949. This may indicate a change in the company's policy of inventory level.
- (iii) The gross profit rate decreased approximately 5% with an increase in sales. A check of the quantities, prices, and calculations of the inventory is indicated.

(3) Securities

- (i) Have been liquidated in large amounts in 1950.
- (ii) The profit on sale of securities shown in the surplus statement is extraordinarily large.

(4) Fixed Assets

- (i) There is an increase in land of $49,200 and an increase in building of only $17,300. This suggests the possibility of a purchase of vacant land for future building.
- (ii) The allocation of cost between buildings and machinery is not given.
- (iii) Furniture and equipment has dropped $24,000 but this is not the type of asset in which a drop of this size would be expected.

(iv) Is there a tax implication on the disposal of furniture and equipment?
(v) It seems peculiar that no profit or loss on disposal of furniture and equipment is shown.

(5) Bonds outstanding
(i) There was a new issue of bonds during the year ending Dec 31 1950.
(ii) No mention is made in the statements of bond discount or premium or expense of issue — an unusual situation.

(6) Reserves for Depreciation
(i) The allocation of reserves as between building and machinery is not given.
(ii) There is an increase in the annual provision on furniture and fixtures although the asset has decreased.
(iii) The adequacy of reserves and the position in relation to the Income Tax Department deserves consideration.

(7) Reserve for Bad Debts
(i) No increase. This is unusual in view of the large increase in accounts receivable.

(8) Accrued Taxes
(i) Details of the prior year tax adjustments through surplus should be examined.
(ii) The accuracy of the figure of the company's tax liability in the light of the tax adjustments should be checked.
(iii) The figure for accrued taxes is almost double the income taxes for the year, which is unusual.

(9) Common Stock
(i) There is an increase of $100,000 of common shares outstanding.
(ii) What was the purpose of the issue and were the proceeds applied to that purpose?

(10) Preferred Stock
(i) All outstanding preferred shares were redeemed during the year.

(11) Sales and Cost of Goods Sold
(i) The gross profit percentage decreased 5% even though sales increased approximately 30%.
(ii) There is an increase of approximately 40% in cost of goods sold.

(12) Administration Expenses
(i) Show an increase in proportion to the sales increase. It is not usual for these expenses to increase as much.

(13) Investment Income
(i) In view of large liquidation of investments special care is necessary to see that all interest and dividend revenue is included.

(14) Income Taxes
(i) Seem approximately right for 1949 but rather low for 1950.

(15) Dividends
(i) A rather high rate.
(ii) The allocation between preferred and common dividends is not given.

(16) Profit on Sale of Investments
(i) Is unusually large in relation to the securities deleted from the balance sheet.

(17) Prior Year Tax Adjustment
(i) What is this, and what effect has it on the calculation of current tax liability?

(18) Surplus
(i) Is a portion of the surplus "distributable", or "reserved for redemption of preferred shares"?

AN ANSWER TO THE ACCOUNTING TEASER

When the merchandise is displayed in a store window.

(For a discussion of this and other possible answers, see Chapter IV, *Asset Accounting* by Paton and Paton (The Macmillan Company, New York, 1952)